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Chapter Twenty
Investment property

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About this publication

The following is a translation of the Investment Property chapter of an IFRS Manual written by Mr Shlomi Shuv, an IFRS expert in Israel. The original document was written in Hebrew and has been translated into English with the assistance of RSM member firm RSM Shiff, Hazenfrazt & Co. in Israel, and with permission from the author.

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1. General

Investment property is real estate property held to earn rentals and/or for capital appreciation. What sets investment property apart from other property held by an entity (owner-occupied property), is that investment property generates cash flows which, to a great extent, are independent of other assets held by the reporting entity. The accounting treatment of investment property constitutes one of those rare cases where certain characteristics of a particular industry segment justify different accounting for similar types of assets. However, the principles for accounting for investment property are not unique to a particular segment or a certain type of entity, but rather arise from the manner in which the reporting entity uses the property. In other words, the principles set out by the international accounting standards for investment property do not apply solely to entities which engage mainly in the leasing of income-generating properties, but rather to all reporting entities which include property held for the purpose of generating rental income and/or for capital appreciation.

International Accounting Standard 40 *Investment Property* ("IAS 40" or "the Standard"), provides for the accounting treatment of investment property and the related disclosure requirements. The Standard's view is that, in light of the nature of investment property, the fair value model is the most relevant for measurement purposes. Under the fair value model, investment property is measured at fair value, with changes in fair value recognised in the statement of comprehensive income. According to this approach, measurement of investment property using the cost method – similarly, for example, to inventories - undermines relevance in the long term (as opposed to inventories, where this irrelevance is eliminated in the short term). However, for mainly practical reasons, the Standard permits the use of the cost model in light of reporting entities' familiarity with this model. According to the Standard, all reporting entities are required to determine the fair value of investment property, whether for measurement purposes (if the fair value model is chosen) or for disclosure purposes (if the cost model is chosen).

Practically speaking, most companies opt to apply the fair value model due, among other reasons, to the fact that the common manner of analysis and comparison in this market segment is based on net assets value (NAV). Thus, for example, a survey carried out in October 2008 found that the vast majority of the companies being surveyed chose to apply the fair value model.

The Standard represents a significant paradigm shift, in that it is the first accounting standard that allows for the application of a fair value model in accounting for non-financial assets. Under this option, the asset is not depreciated systematically and all changes in fair value during the period are recognised in the statement of comprehensive income. Consequently, the option of adopting the fair value model creates a situation where the statement of comprehensive income includes a mixture of realised gains and losses (e.g., rental income or maintenance expenses) and unrealised gains and losses (appreciation or impairment). This stands in contrast to the revaluation method allowed under IAS 16 *Property, Plant and Equipment*, whereby the increase in the revaluation amount and its reversal is recognised directly in other comprehensive income, under the revaluation surplus line item. Furthermore, according to the Standard, the different nature of investment property, as compared with the reporting entity's property, plant and equipment, requires that it be presented separately from property, plant and equipment in the statement of financial position (even when adopting the cost model for the investment property).

In 2008, IAS 40 was amended, taking the comprehensive adoption of the fair value model one step further. Under the amendment, companies should also apply the Standard to investment property under construction or under development for future use as investment property. Accordingly, if a reporting entity measures investment property using the fair value model, it is also required to measure investment property under construction or under development at fair value, provided that fair value can be measured reliably. The measurement of investment property using the fair value method causes numerous application problems. Thus, for example, one of the key issues is how to determine the fair value of property under construction when the stage of completion is relatively low and only a few leases have been signed. In these cases, uncertainty is relatively high, and so this raises the issue of whether the investment property can be measured reliably.

It should be noted that in certain countries, companies are required by regulation to provide detailed information regarding material investment property in their board of directors' report. In particular, companies disclose their valuation methods, their underlying assumptions and sensitivity tests for investment property if this constitutes a material segment in their operations. Furthermore, such companies include the valuation method applied to each investment property item, the discount rates used, and the effect of each investment property item on their results. In addition, many companies in Europe commonly provide detailed information in their financial statements which relies on European Public Real Estate Association (EPRA) recommendations. This information includes a general framework regarding the manner of presenting the financial statements and the required disclosures, various principles used in carrying out valuations, tables analysing and comparing the reporting entity's performance over different periods, and various methods for calculating net asset value (NAV) and the reported results based on various assumptions which may be much more relevant to investors than the manner in which they are presented in the financial statements.

2. Scope

The Standard applies to the recognition, measurement and disclosure of investment property. The Standard applies, among other things, to the measurement of interests in investment property under a finance lease in the financial statements of a lessee and the measurement of investment property under an operating lease in the financial statements of a lessor. It is important to emphasise that other issues related to the accounting treatment of leases (e.g., classification of leases and additional matters) are dealt with in IAS 17 *Leases* (see also Volume C, Chapter 16 - Leases). The Standard does not apply to biological assets related to agricultural activity, which are subject to IAS 41 *Agriculture,* nor does it apply to mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

3. Definition of Investment Property

3.1 Owned Property (or Leased under a Finance Lease)

Investment property is defined as property (land or a building, or part of a building, or both) held by the owner or by a lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for:

a. Use in the production or supply of goods or services or for administrative purposes; or,
b. Sale in the ordinary course of business.

The Standard regards investment property as being held to earn rentals or for capital appreciation. Therefore, what distinguishes investment property from other types of property held by a reporting entity (such as owner-occupied property) is that investment property generates cash flows which, to a great extent, are independent of other assets held by the entity. It should be noted that furniture and equipment which are physically attached to a building which constitutes investment property, such as elevators, air conditioning systems, decorative furnishings and wall-to-wall carpets, are considered part of the investment property and are not classified separately under property, plant and equipment. Thus, all of the property held by a reporting entity (whether owned or under a finance lease) may be classified into three categories;

a. Owner-occupied property - property used in the production or supply of goods or services or for administrative purposes.
b. Investment property.
c. Property held as inventory - property held for sale during the ordinary course of business.

Following is a discussion of how various types of property meet the definition of investment property:

A. Land held for a particular purpose

First, it is important to examine the purpose for which the land is held. If the land is held for long-term capital appreciation, it constitutes investment property. However, if the land is held for sale in the short term during the ordinary course of business, or is under construction or development for such sale, it constitutes inventory and not investment property, and should therefore be treated in accordance with IAS 2 *Inventories*. For example, a contracting company acquires land with the aim of constructing a residential building for sale. Until the construction of the building is completed, the company should classify the land and subsequent construction costs as inventories.

However, it is sometimes difficult to distinguish between property held for sale during the ordinary course of business (inventory) and property held for appreciation (investment property). The international accounting standards do not define the exact meaning of the terms "short term" and "long term". It seems that the main criterion for classifying property must rely on a reporting entity's business model, i.e., the reporting entity's intentions regarding the property. Furthermore, it seems that the holding period (short term or long term) must be examined in light of this criterion and not according to clearly defined timeframes. For example, if a company which does not deal in real estate exercises an option acquired several years earlier to acquire land in an urban area, but has yet to decide whether to develop the land for sale or to sell it without development (with such decision to be made in the short term), it seems that the property would constitute inventory, as the land is held for sale or for development and sale during the ordinary course of business. Accordingly, a company which trades in real estate should classify its property holdings as inventories if it intends to sell the property during the ordinary course of business specific to its operations. On the other hand, a company dealing in income-generating property, which engages in long-term investments in property and the leasing thereof, should classify a given investment in property as inventory if, at the time of acquisition, it intends to sell the investment during its ordinary course of business (even if it is currently leasing out the property temporarily).

B. Land held for undetermined future use

When land is held for undetermined future use, i.e., the reporting entity has not yet determined whether the land will be used as owner-occupied property or for sale during the ordinary course of business in the short term, the land should be regarded as being held for capital appreciation. In other words, according to the Standard, it should be regarded as investment property. For example, a company acquires land in a distant (and relatively inaccessible) area at a low cost. The government plans to develop the area as an industrial park within a few years' time, and - if such plans materialise - the value of the land will increase significantly. The company's management has not yet determined the manner in which it will use the land. It should be emphasised that the question of how to classify land held for undetermined future use must be examined on a property-by-property basis, while taking into account the reporting entity's intentions as expressed, for example, in board of directors' meetings, and in light of the entity's ordinary course of business.

C. Owned Building leased out under operating lease

A building owned by a reporting entity, including a building held by the reporting entity under a finance lease, which is leased out under an operating lease (rented out) to a third party, constitutes investment property. This conclusion will not change even in the case of a vacant building held to be leased out under an operating lease. For example, a company has built an office building on land leased from the state for a period of 40 years (without transfer of ownership at the end of the term). Accordingly, the lease from the state has been classified as an operating lease. The company leases out the office building to "anchor" lessees under long-term leases. In this case, the building component should be treated as investment property. As for the land component, considering that under IAS 17 the land is leased under an operating lease, it should be treated as investment property if, and only if, the reporting entity chooses to adopt the fair value model for the land and the fair value model has also been chosen in accounting for all the investment property owned by that reporting entity (see Section 3.2

below). It should be noted that if the reporting entity chooses to classify the leased land as investment property, the land and building should be accounted for jointly.

D. Owner-occupied property

Owner-occupied property does not constitute investment property. Owner-occupied property may include property held for future use as owner-occupied property, property held for future development and for subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rental fees at market prices), and owner-occupied property awaiting disposal. Consequently, such property should be subject to IAS 16.

E. Property under construction or development for future use as investment property

In the past, property under construction or development for future use as investment property was excluded from the Standard. Thus, this type of property was treated in accordance with IAS 16, similarly to property, plant and equipment under construction or development.

In 2008, the Standard was amended so as to include in its scope investment property under construction or development for future use as investment property. Thus, if the reporting entity measures investment property according to the fair value model, it is required to measure investment property under construction or development at fair value as well, provided that fair value can be measured reliably. This change was due to experience gained with time regarding the measurement of the fair value of investment property in general, and of investment property under construction and development in particular. Thus, for example, one of the common methods used to measure investment property under construction that has evolved over the years is the residual method, which determines the value of investment property under construction according to the value of a constructed asset leased out to third parties. For more information, see Section 5.4.3 below.

F. Property held in part for use and in part for investment

In some cases, a portion of a property may be held to earn rentals or for capital appreciation, while another portion is held for use in the production or supply of goods or services or for administrative purposes. In accounting for such cases, it is first necessary to determine whether the different portions can be sold separately (or leased out separately under a finance lease). If it is possible to sell the portions separately, each portion of the property should be treated separately. If it is impossible to sell them separately, the entire property should be treated as investment property only if the owner-occupied portion (for use in the production or supply of goods or services or for administrative purposes) is insignificant. In other words, when the portions cannot be sold separately and a significant portion of the property serves as owner-occupied property - the entire property should be treated in accordance with IAS 16.

The above assessment is primarily legal. For example, a company which owns a multi-story office building for lease occupies three stories of the building for use as its offices. Legally, the company can sell each story separately, and so the stories which are leased out should be classified as investment property. In another example, a company owns a luxury hotel. The hotel complex includes a casino in a separate building, which serves tourists and other persons who are not guests of the hotel. The company operates the hotel and leases out the casino to an independent operator for a fixed rent, with the risks and rewards associated with operating the casino being the operator’s (furthermore, let us assume that the independent operator would not have operated the casino were it not for its proximity to the hotel). Legally speaking, the casino can be sold separately. It seems that the casino shall be classified as investment property, while the hotel should be classified as property, plant and equipment.

It should be noted that the assessment of separability should be carried out according to the legal situation at the reporting date. Thus, for example, the fact that the reporting entity expects that in future periods it will be able to classify a portion of the property as investment property and another portion as owner-occupied property does not affect the property's presentation at the reporting date. Consequently, the asset should be presented as investment property or as owner-occupied property according to the present situation. This begs the question of how to interpret the term "insignificant". Although the Standard does not provide a definition for the term, it seems that the issue must be examined on a property-by-property basis, using a reasonable measurement base (usually a value ratio or area ratio). Furthermore, it seems that own-use of less than 5% of the chosen measurement base may be considered insignificant.

G. Property whose lease entails the provision of ancillary services

There are cases where a reporting entity renders ancillary services to the lessees of its property. In such cases, in order to classify the property as investment property or as owner-occupied property, an entity shall examine the nature of the services provided to the lessees. If these services are insignificant, i.e., the services constitute a relatively insignificant component compared to the overall arrangement, the property shall be classified as investment property. For example, when a company that owns an office building being leased out provides its lessees with security and maintenance services. On the other hand, if the services are significant, the property should be treated as owner-occupied. For example, if a company owns and manages a hotel, there is no doubt that the services rendered to guests constitute a significant part of the overall arrangement.

How should one account for cases where the reporting entity transfers part of its responsibility for the ancillary services to third parties? For example, in a case of a company which owns a hotel but employs a third-party management company to provide the ancillary services. In this case, in order to determine whether the services are significant, the nature of the agreement with the management company should be examined. In the following extreme cases, the distinction is relatively simple:

a. If the agreement with the management company leaves the owner with the risk for variations in the cash flows generated from the hotel services (e.g., the management company receives a fixed fee, while all revenues are attributed to the owner), the management company is actually providing services to the owner (similarly to employees). Thus, the property should be classified as owner-occupied property.
b. On the other hand, if the owner's status is similar to that of a passive investor (e.g., the owner receives a fixed fee for the hotel while all revenues and expenses for the hotel are attributed to the management company), the property should be classified as investment property.

However, management agreements may vary and there may be cases where making the above distinction is more difficult. In any case, it should be emphasised that determining whether the services are significant requires the reporting entity to exercise judgment. The Standard states that a reporting entity shall apply the criteria on which it based its judgment consistently and in accordance with the definition of investment property.

It seems that in order to classify the property in those cases where the management agreement falls between the above two extremes, , the following factors, among other things, shall be taken into account:
a. Under the management agreement, which party can make operating and financial decisions regarding the property's operation (e.g., terms and prices offered to customers, recruitment and dismissal of employees). In other words, is the owner's ability to intervene greater than that granted under an ordinary owner-tenant relationship? If so, this will serve to indicate that the property is owner-occupied.
b. Is the calculation of the owner's return fixed (more indicative of investment property) or does it represent a percentage of the property's actual results (more indicative of owner-occupied property)?
c. Is the contract for a long and predetermined period (more indicative of investment property), or is it renewed annually, or may be terminated even earlier (more indicative of owner-occupied property)?

In any case, an entity shall examine all the relevant factors and circumstances. It seems that when an owner bears a significant operating risk together with the other party (i.e., the management company), the owner, in fact, participates in the transfer of the goods and services, and so the property cannot be classified as investment property.

3.2 Property Interest Held by a Lessee under an Operating Lease

The Standard permits a reporting entity to classify and account for a property interest it holds as a lessees under an operating lease as investment property. Such classification may be made if, and only if, the property would have met the definition of investment property and the reporting entity applies the fair value model to the leased asset (see Section 5.3 below). In these cases, the lessee should, in fact, account for the lease as a finance lease.

Although the Standard provides the above classification option for each property interest separately (it may be applied to one property and not to another), it only stands if the reporting entity adopts the fair value model for all its investment property. In other words, from the moment that the above classification option has been chosen for a certain property interest held under an operating lease, all the reporting entity's property classified as investment property - whether owned or under a finance lease - should be accounted for using the fair value model. For example, a company leases land for a period of 60 years in consideration for CU 10 million, with the lease being classified as an operating lease in accordance with IAS 17. The company constructs an office building on the land with an expected useful life of 40 years (the building is owned by the company). In this case, the building constitutes investment property. Furthermore, the company may choose to classify its operating lease of the land as investment property (if it applies the fair value model).

3.3 Consolidated Financial Statements

In consolidated financial statements, the classification of investment property must be examined at the group level. Therefore, there may be differences between a property's classification in the individual financial statements of the group companies and its classification in the consolidated statements. For example, a subsidiary owns an office building which is leased out to its parent company. Although the property is classified in the consolidated financial statements as owner-occupied property, from the perspective of the subsidiary itself, the property constitutes investment property. Thus, adjustments must be made to the subsidiary's individual financial statements when including them in the consolidated statements.

It should be noted that under the international standards' view of the separate financial statements of a parent company, if, for example, a parent company leases out an office building to its subsidiary, the building would be classified as investment property in its separate financial statements. However, this classification would not hold for the consolidated financial statements. It seems that the above principle does not apply to companies treated according to the equity method, as they are not part of the group.

4. Recognition and Initial Measurement

4.1 Recognition

An investment property should be recognised as an asset only when both of the following conditions have been met:
a. It is probable that the future economic benefits associated with the property will flow to the reporting entity; and,
b. The property's cost can be reliably measured.

These principles for recognition should be applied to all costs in respect of investment property at the time in which they are incurred, whether these are initial costs for the acquisition of the investment property or subsequent costs.

4.2 Initial Measurement upon Recognition

4.2.1 General

Investment property is initially measured at cost (including transaction costs), unless the investment property has been reclassified from another category in the statement of financial position (e.g., property, plant and equipment reclassified into investment property). The cost is the amount of cash or cash equivalent paid or the fair value of another type of consideration given to acquire or construct an investment property, or (when applicable) the amount allocated at the time of initial recognition in accordance with the specific requirements of other accounting standards, such as IFRS 2 *Share-based Payment*. Accordingly, the cost of an acquired investment property includes the cost of its acquisition and any additional costs which are directly attributable to bringing the asset to the condition necessary for it to be used as intended. Other directly attributable costs include, for example, professional consultation fees for legal services, property transfer taxes and other transaction costs. The principles for capitalising costs as part of the investment property are identical to those for capitalising costs as part of property, plant and equipment under IAS 16.

The following costs should not, in any case, be capitalised as part of the investment property:
a. Start-up costs, unless these costs are necessary in order to bring the property to the condition necessary for its intended use.
b. Operating losses incurred before the investment property has reached the planned occupancy rate.
c. Amounts attributed to abnormal amounts of wasted materials, labour, or other resources incurred during the construction or development of the property.

When payment for the investment property is made by way of credit, its cost should be calculated according to the cash price equivalent, similarly to the principles prescribed for property, plant and equipment. The difference between this amount and the total amount of the payments should be recognised as interest expense over the credit period.

4.2.2 Measuring the cost of investment property in special cases

A. Investment property interests held under a finance lease

Pursuant to IAS 17, the initial cost of interests in an investment property held under a finance lease is determined according to the property's fair value or the present value of the minimum lease payments, the lower of the two. Furthermore, under the aforementioned standard, an equivalent amount should be recognised as a liability for the finance lease agreement.

However, according to the Standard, there should not be any difference between the value recorded for the aforesaid interests in accordance with IAS 17 and the fair value as defined in the Standard. This is due to the fact that in a lease priced at market terms, the fair value of the interest in the leased property at the time of acquisition less any projected lease payments including those related to recognised liabilities should be zero. Fair value does not change even if, for accounting purposes, a leased asset and a liability are measured at fair value or at the present value of the minimum lease payments. Therefore, if a reporting entity adopts the fair value model, the transition from measurement at cost to measurement at fair value at the time of acquisition should not create any initial profit or loss.

B. Exchange of Assets

An investment property can be acquired in exchange for a non-monetary asset. In this case, the cost of the asset received is measured according to the fair value of the asset given up or according to the fair value of the asset received if it serves as clearer evidence of this cost. This, unless (a) the exchange transaction lacks commercial substance; or (b) it is not possible to reliably measure the fair value of the asset received or of the asset given up. If, as aforesaid, the investment property is not measured at fair value, its cost should be measured according to the carrying amount of the asset given up.

Commercial substance
In order to determine whether an asset exchange has commercial substance, an entity shall examine the extent to which a reporting entity's future cash flows are expected to change following such a transaction. According to the Standard, the exchange transaction is of commercial substance if the following change is significant relative to the fair value of the asset given up:
- The configuration (risk, timing and amount) of the cash flows from the received asset is different from the configuration of the cash flows from the asset given up; or,

- The entity-specific value of the portion of the entity's operations affected by the transaction (post tax), changes as a result of the exchange.

The Standard notes that the result of these analyses may be clear without the entity having to perform detailed calculations. The guiding principle outlined above is also relevant, subject to the necessary changes, in cases where a single asset is not exchanged for another single asset. For example, the receipt of a number of investment properties or the transfer of a number of non-monetary assets, or when the consideration is comprised of a combination of monetary and non-monetary assets.

Reliable measurement
The fair value of an asset for which there are no comparable transactions available on the market can be reliably measured if the variability within the range of the reasonable fair value estimates is not significant for that asset or if it is possible to reasonably assess the probabilities for the various estimates in the range and use them in estimating the asset's fair value.

4.3 Costs Incurred after Initial Recognition

When accounting for costs incurred following the acquisition or the completion of construction carried out so as to add to an investment property, to replace any part thereof or to maintain it, an entity shall examine whether the above recognition principles are met. Therefore, at the time in which the subsequent costs are incurred, assuming that there is a reliable estimate for them, an entity shall examine whether the condition for recognition – whereby it is probable that the associated future economic benefits will flow to the reporting entity – is met.

Common subsequent costs are accounted for as follows:

A. Ongoing maintenance costs

An investment property's ongoing maintenance costs mainly include costs for labour and consumables, and it is possible to include the cost of small parts used for repairs and maintenance to the property in order to preserve a certain level of future economic benefits (preservation of present condition). Ongoing maintenance costs as aforesaid do not constitute part of the cost, and should therefore be recognised in the statement of comprehensive income at the time in which they are incurred.

B. Replacement of previous items

Costs incurred after the date of recognition may include the replacement of previous parts of an investment property, such as the replacement of interior walls. In these cases, an entity shall recognise the cost of replacing such parts as part of the carrying amount of the investment property, if the criteria for recognition are met. Furthermore, the carrying amount of the replaced parts should be derecognised in accordance with the derecognition requirements for the asset.

Accounting for subsequent costs is similar to accounting for subsequent costs for property, plant and equipment as prescribed under IAS 16 (see also Volume B, Chapter 19 - Property Plant and Equipment, Section 3.3). It is important to emphasise that when dealing with a prolonged renovation, an entity shall examine the principles for capitalising borrowing costs.

It should be noted that if the fair value model is applied, it seems that this distinction is rendered unnecessary, as the investment property should, in any case, be presented at fair value in each reporting date, with changes being recognised in the statement of comprehensive income. As a result, if the replacement increases the value of the asset, this is reflected in the fair value of the investment property at the reporting date.

5. Measurement after Initial Recognition

5.1 General

5.1.1 Adoption of accounting policy

The Standard allows a reporting entity to choose, for all of its investment property, whether to apply the fair value model or the cost model as an accounting policy. This raises the question of whether a reporting entity which chooses to adopt the revaluation method under IAS 16 for its property, plant and equipment, may choose the cost model for its investment property (rather than the fair value model). It seems that according to the Standard, the answer is yes, since these are essentially different assets. However, the Standard's approach is that the fair value model is more relevant to the various users of the financial statements and so should be given preference over the cost model. It should be noted that when a reporting entity has chosen to classify property interests it holds as a lessee under an operating lease as investment property (see Section 3.2 above), it may not choose between the models as aforesaid, and must apply the fair value model to all its owned investment properties and/or under finance leases. It should be noted that, practically speaking, most companies choose to apply the fair value model due, among other reasons, to the fact that the common method for analysis and comparison in this industry segment is based on the net assets value (NAV).

The chosen accounting policy must be applied consistently to all investment properties (except for internal property funds, see Section 5.1.2 below) and throughout the different reporting periods. It should be remembered that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that a reporting entity may initiate a change in its accounting policies only if such a change results in a more appropriate presentation of transactions, events or circumstances in that entity's financial statements. Regarding investment property, the Standard notes that it is not likely that a change from the fair value model to the cost model will result in better presentation. Therefore, this may indicate the Standard's preference for the fair value model.

5.1.2 Internal property funds

Certain insurers and other reporting entities operate internal property funds that issue notional units. Some of these units are held by investors in linked contracts, while others are held by the reporting entity. These notional units constitute a liability which bears a return that is directly linked to the fair value of the investment property included in the fund or to returns from specified assets which include the investment property in the fund.

The Standard allows a reporting entity to choose a different model in accounting for investment property included in the fund than that used in accounting for other investment properties held by it. However, an entity may not apply different models across investment properties included in the fund, i.e. - measure some properties included in the fund at cost and others at fair value. When the reporting entity chooses a different model for measuring the investment property in the fund than that chosen for its other investment property, then the sale of investment property between the asset pools (measured using different models) should be recognised at fair value and the cumulative change in fair value should be recognised in the statement of comprehensive income. Thus, if an investment property from a pool of assets to which the fair value model is applied is sold to a pool to which the cost model is applied, the fair value of the property at the time of sale constitutes its cost.

5.2 The Cost Model

If the cost model is chosen, all of the reporting entity's investment property shall be measured, following initial recognition, in accordance with the requirements set forth for this model under IAS 16, except for investment property which meets the criteria for classification as being held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Investment property which meets these criteria should be measured in accordance with the requirements of this standard starting from the date on which the criteria are met. In general, an asset classified as held for sale is not systematically depreciated and is measured according to the lower of its cost and the fair value net of costs to sell. When applying the cost method, attention must be given to applying the component approach in calculating depreciation. It should be noted that furniture and equipment which are physically attached to a building - such as elevators, air conditioning systems, decorative furnishings and wall-to-wall carpets - are considered part of an investment property and are not classified separately under property, plant and equipment.

As regards presentation, even when the cost model is adopted, according to the Standard investment property should be classified separately in the statement of financial position under investment property. Moreover, if the cost model is adopted, it would still be necessary to calculate the investment property's fair value for disclosure purposes, according to the same bases used for its calculation under the fair value model. Therefore, all the principles for determining fair value under the fair value model apply in this case as well, including those specific circumstances where the Standard recognises that it is impossible to obtain a reliable estimate of fair value (see Section 6 below).

5.3 The Fair Value Model

5.3.1 Guiding principle

When the fair value model is chosen, all the reporting entity's investment property must be measured at fair value following initial recognition, unless it is impossible to obtain a reliable estimate of fair value (see Section 5.4 below). Gains or losses from changes in the fair value of investment property should be recognised in the statement of comprehensive income in the period in which they arose. Section 6 below provides a detailed discussion of the method for determining fair value.

In 2008, the Standard was amended so as to bring investment property under construction or development for future use as investment property within the scope of the Standard. Consequently, if a reporting entity measures investment property using the fair value model, it is required to measure investment property under construction or development at fair value, provided that it can be measured reliably.

When investment property is measured using the fair value model, how should transaction costs that have been incurred be accounted for, as the fair value of the property does not take such costs into account? According to the Standard, transaction costs incurred by the acquirer of an investment property are to be included in the carrying amount of the asset. However, if the reporting entity applies the fair value model, it seems that these costs should be recognised in the statement of comprehensive income in subsequent periods. Practically speaking, it seems that these costs can be recognised in the statement of comprehensive income upon subsequent revaluation to fair value. For example, at the start of the reporting period a company acquires an investment property in return for CU 10 million, and incurs transaction costs in the amount of CU 200,000. At the end of the reporting period, no change has taken place in the fair value of the investment property. Thus, the company should recognise a loss of CU 200,000 for that reporting period.

5.3.2 Use of an independent valuer

The Standard encourages, but does not require, that the fair value of an investment property be determined based on a valuation conducted by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. Although the Standard does not mandate that **an independent** valuer be engaged as aforesaid, it prescribes detailed requirements for determining fair value (see Section 6 below). One example is the requirement to rely primarily on current prices in an active market for similar properties in the same location and in the same condition, while taking care to identify any differences related to the nature, location or condition of the property, or to the terms of the lease and other contracts related to the property.

Therefore, it seems that in order to conform to the requirements set forth by the Standard for determining fair value, when making the practical decision of whether to employ the services of **an independent** valuer, a reporting entity must take into account whether it has an employee (or employees) of relevant skills or professional qualifications and whether it has information regarding transactions in similar properties on the market. Furthermore, it seems that when the property (or properties) being valued is material to the reporting entity's statement of financial position, then the more volatile the market, the more crucial it is to employ **an independent** valuer. For example, it seems that in case of an investment property for which information can be readily obtained on transactions in similar properties, it will be possible to employ **an independent** expert at relatively long intervals in those periods when market volatility is low (e.g., summoning the expert once annually). During the reporting periods, between **independent** valuations, it seems that it is possible to use internal valuations which estimate changes in fair value. However, in periods of increased market volatility, it may be necessary to obtain **independent** valuations in each reporting period. In practical terms, it should be noted that many entities which hold a relatively large portfolio of income-generating properties tend to conduct **independent** valuations in some of the reporting periods, while in other periods, if no material changes have occurred in rental fees, occupancy and/or discount rates, an internal valuation is carried out. Furthermore, if the property being valued in the case above is not material to the statement of financial position, it may not be necessary to engage **an independent** valuer. However, in the above example, if we now assume that the reporting entity cannot obtain information about transactions in similar properties, then it may be necessary to engage **an independent** valuer at least in order to support the entity’s valuation regarding fair value.

5.4 Inability to Determine Fair Value Reliably

5.4.1 General

There is an assumption (rebuttable), whereby a reporting entity can determine the fair value of investment property on an ongoing basis. However, in extraordinary cases, there is clear evidence, as early as at the time of acquiring an investment property, that the reporting entity will not be able to reliably determine the fair value of the property on an ongoing basis. This means that the variability of the range of reasonable fair value estimates is expected to be so high, and it is expected to be so difficult to estimate the reasonability of the various results, that the usefulness of a single fair value estimate is completely undermined. These cases occur only when comparable market transactions are rare and reliable alternative fair value estimates (e.g., discounted cash flow forecasts) are unavailable. For example, a company dealing in investment property completes the construction of a new entertainment complex, which it intends to lease under an operating lease to a third-party operator. There is no active market for the complex, and the sale of the complex is, to a significant extent, subject to negotiation between the parties. It seems that there is no inability to determine fair value, since fair value can be estimated by calculating the present value of the future lease proceeds.

5.4.2 Existing investment property

As regards investment property which is not under construction or development, the Standard prescribes that in those cases where fair value cannot be reliably measured, an entity shall measure the investment property using the cost model prescribed under IAS 16 until the investment property is disposed of. To this end, it should be assumed that the residual value of the investment property is zero. This investment property should continue to be measured using the cost model until it is disposed of. In this case, despite using the cost model for one investment property, other investment properties are to be measured at fair value.

It is important to emphasise that the above assumption may be rebutted only at the time of initial recognition (i.e., at the time of acquisition or reclassification from another line item in the statement of financial position). Therefore, if an investment property was previously measured at fair value, an entity shall continue to measure it at fair value until its disposal or until the property is reclassified as owner-occupied property or as inventory, even if comparable market transactions become less frequent or market prices are not as readily available.

5.4.3 Investment property under construction or development

As mentioned in Section 3.1 above, the Standard states that investment property under construction or development for future use as investment property falls within the scope of the Standard. Therefore, if the reporting entity measures investment property using the fair value model, it must measure investment property under construction or development at fair value, provided that fair value can be measured reliably. If the reporting entity determines that the fair value of an investment property under construction or development cannot be measured reliably but expects that a reliable measurement will be possible at a later date, it must measure the property using the cost model until such time as fair value can be reliably measured or until construction is completed, the earlier of the two.

Measurement of investment property under construction or development at fair value creates numerous practical problems. In particular, it raises questions regarding the date on which it is possible to reliably determine the fair value of a property, with the reporting entity being required to apply the fair value model after such date if it has indeed chosen this model. In practice, there are several different approaches to the matter. On the one hand, there is the argument expressed in an International Valuation Standards Council (IVSC) publication, whereby it is impossible to reliably determine the fair value of investment property under construction only in extraordinary cases. On the other hand, there is the argument whereby during the initial stages of construction, when the stage of completion is relatively low and only a few leases have been signed, construction risks are so high that fair value cannot be reliably measured. In light of the different approaches, it seems that different reporting entities will need to determine different thresholds (quantitative as well as qualitative) while exercising judgment and consistent application over the different reporting periods.

6. Determining Fair Value

6.1 Definition of Fair Value

The fair value of investment property is the price at which the property can be exchanged between knowledgeable, willing parties in an arm's length transaction.

There are several points of emphasis in applying this definition:

A. Transaction costs

Pursuant to the definition, fair value is determined without any deduction for transaction costs which the entity may incur upon selling a property or upon otherwise disposing of it.

B. Special circumstances

Pursuant to the definition, fair value does not take into account inflated or reduced prices due to special terms or circumstances, such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale.

C. Transactions between "willing parties"

A transaction between willing parties is one that is undertaken between parties with no special relations or particular connections, such as may result in transaction prices being uncharacteristic of market conditions. It should be assumed that the transaction is made between unrelated parties, with each acting independently. Furthermore, the factual circumstances regarding the actual owners of the investment property are not part of the price, as a willing seller is a hypothetical owner (e.g., a willing seller will not take into account the unique tax circumstances of the actual investment property owner).

D. "Knowledgeable parties"

The term "knowledgeable parties" included in the definition means that both willing parties have received reasonable information regarding the nature and characteristics of the investment property, its actual usage, its potential usage, and the market conditions as of the reporting date. A willing buyer is interested in buying, but not coerced into doing so. Such a buyer is not overly eager and is not adamant in its intent to buy at any cost. Such a buyer will not pay a price higher than the asking price on a market which includes willing, knowledgeable buyers and sellers. Similarly, a willing seller is not overly eager to sell or coerced into selling, and is not willing to sell at any price. Moreover, it is not a seller willing to wait for a price which is considered unreasonable at current market conditions. A willing seller is one who is interested in selling an investment property at market conditions at the best possible price.

E. Market conditions at the reporting date

Fair value is required to reflect market conditions as at the **reporting** date. This requirement is significant since the fair value estimate is determined for a particular date. Therefore, as market conditions are subject to change, the amount reported as fair value at a particular date may be incorrect or inappropriate at another. Consequently, the definition of fair value assumes that the sale transaction and its closing are carried out simultaneously. Furthermore, the fair value of investment property reflects, among other things, leasing income from current leases and reasonable and well-founded assumptions, which represent the assumptions of a willing buyer and a willing seller regarding leasing income from future leases in light of current market conditions.

F. Fair value versus value in use

Fair value differs from value in use as defined in IAS 36 *Impairment of Assets*. While value in use reflects the reporting entity's estimates, including the effects of entity-specific factors, fair value reflects all participants in the market. Therefore, in estimating the fair value of an investment property, en entity shall not include additional value created by a property portfolio containing properties in different locations, synergy between investment property and other assets held by a reporting entity, statutory rights or restrictions which are specific only to the present owner, and tax benefits or liabilities specific only to the present owner.

On the other hand, fair value shall be calculated according to the optimal use (highest and best use) of the property, and not necessarily according to its present use. For example, land with a golf course can be easily converted into a parking lot, which would yield higher income. While the value in use of the land reflects its present use (as a golf course), the fair value of the land should reflect its optimal use (a parking lot). This means that fair value is the highest possible value of the property evidenced by market data, taking into account each possible use - both financial and legal - that is sufficiently justified and expected.

Furthermore, it seems that the allocation of fair value to an investment property's components must be carried out consistently with the calculation of fair value according to optimal use. The following example illustrates this point: Let us assume that a company owns investment property (a rentable warehouse) whose carrying amount is CU 10 million. The carrying amount of the property is comprised of land (CU 8 million) and the warehouse built on that land (CU 2 million). A

valuer reaches the following conclusions: The fair value of the warehouse (present use) is CU 10.5 million (comprised of land value - CU 8.5 million and the value of the building - CU 2 million). On the other hand, the value of the land according to an alternative, optimal use (office building) is CU 12 million (but, in this case, the building would have to be demolished - fair value of zero). Even if the company's management does not intend to change the current use of the property, the fair value of the property is CU 12 million. Therefore, as this value represents the fair value of the land alone, the value of the building must be measured at zero, and the value of the land - at CU 12 million.

6.2 The Fair Value Hierarchy

The best indication for fair value is usually current prices on an active market for similar properties in the same location and in the same condition, subject to similar leases and other contracts. Therefore, an entity shall exercise caution in identifying all the differences pertaining to the nature, location, and condition of a property or to the lease terms or the terms and conditions of other contracts associated with the property. In the absence of current prices on an active market as aforesaid, an entity shall consider information from a variety of sources, including:

A. Current prices on an active market for properties of a different nature, condition or location, adjusted so as to reflect those differences.
B. Current prices for similar properties on less active markets, with the necessary adjustments to reflect any changes in the economic conditions from the date on which the transactions took place at these prices.
C. Discounted cash flow forecasts, if reliable estimates for future cash flows exist, supported by the terms and conditions of the lease or other existing contracts (all of them) and by external evidence (if available), such as current rental fees for similar properties in the same location and in the same condition. Furthermore, in discounting, an entity shall use discount rates which reflect current market assessments for uncertainty regarding the amount and timing of these cash flows.

In certain cases, the above three sources may lead to different conclusions regarding the fair value of an investment property. Therefore, an entity shall consider the reasons underlying these differences in order to reach the most reliable estimate of fair value within the range of reasonable fair value estimates. For general guidelines regarding the fair value hierarchy, see Volume A, Chapter 3 - Framework for the Preparation and Presentation of Financial Statements, Section 7.3.2.

6.3 Methods for Estimating Fair Value

The Standard does not specify methods to be used in estimating fair value (valuation methods). However, in developing the Standard, the IASB relied on guidelines issued by the International Valuation Standards Council (IVSC).

The valuation methods recognised by the IVSC are as follows:

A. The sale comparison method

According to this approach (also known as the "market approach"), available information regarding market prices for similar properties is gathered, whether these are stock exchange prices for listed assets or prices from recent transactions. Then, adjustments are made to reflect the differences between the property being valued and the comparable property. These adjustments may be influenced by such factors as the location of the property, the timing of the sale, and physical characteristics of the property. The comparative analysis focuses on the similarity as well as on the differences between properties and transactions which affect the value of the property being valued, including the various motives of the buyers and sellers, the financial and market conditions at the time of sale, as well as the size, location and physical and economic characteristics of the property. The various comparative criteria are assessed in order to estimate their expected impact on fair value. The market approach is applied when there is sufficient available market data. However, its reliability decreases when a drastic change in market conditions takes place, when there is increased volatility in prices, or when there is a limited number of transactions in the market.

B. The income capitalisation method

According to this approach, the fair value of a property is derived from the present value of the cash flows expected to be generated by the property over its remaining useful life. In applying this method, an entity shall first estimate the future cash flows expected from a comparable property (cash-based estimate of future revenue and expenses), based - among other things - on analysis of financial and operating data. Then, an entity shall discount the future cash flows at a rate of return which should reflect the time value of money and the risk embodied in the property. In addition, the calculation must include any residual value. One way of carrying out valuations using the income capitalisation method includes the discounting of the net leasing income according to appropriate rates of return.

C. The cost method

The cost method estimates the fair value of a property based on the property's value plus the depreciated cost of any improvements made to the property, with these being estimated according to the reconstruction cost less accumulated depreciation or according to the replacement cost less depreciation and allowance for impairment.

D. The residual method

This approach is, in fact, a combination of the income capitalisation and cost methods. It is usually used to evaluate investment property under construction or development. According to this method, the valuation of an investment property under construction or development begins with the present market value of a property, assuming that its construction has been completed at the time of valuation. From this amount, an entity shall deduct the present estimate of the expected costs for completing construction and development, including proper adjustment for risk, so as to arrive at the property's fair value in its current state.

Accordingly, in calculating the value of investment property under construction or development, an entity shall take into account the following criteria:

1. Completed property - the value of the property had the project been completed on the date of the valuation. This assessment should reflect the current value of a completed investment property with similar characteristics to those of the property under construction.
2. Lessees – in the absence of pre-signed lease agreements, an entity shall include an allowance for the reasonable time that will be necessary to bring the property to maximum possible occupancy at present market conditions.
3. Construction costs - costs incurred prior to the valuation should not be taken into account. Construction costs should be based on an estimate of the expected costs for completing construction.
4. Finance costs - the costs for financing the remaining construction costs must be taken into account even if the reporting entity is financing the acquisition through equity.
5. Developer's margin - the property's value must be decreased in respect of the return that would have been expected by a potential buyer of property under construction. This amount must reflect the risks embodied in completing construction and achieving the expected level of income or appreciation.
6. Additional costs.

6.4 Factors to be Excluded when Determining Fair Value

6.4.1 Future capital investment

The fair value of an investment property must be measured according to its present condition. Therefore, the measurement need not reflect future capital investments which may improve or expand the property, nor future benefits derived from such an investment. It should be noted that the residual method would appear to contradict this statement. However, it seems that the term “future capital investment” refers to cases where the property is already fulfilling its intended use. It should be noted that, practically speaking, the residual method is the leading method used in evaluating investment property under construction or development.

6.4.2 Related assets and liabilities

In determining the carrying amount of investment property measured using the fair value model, an entity shall avoid double counting of assets and liabilities recognised separately from investment property in the statement of financial position. For example, a company which leases an office on a furnished basis recognises the furniture and the building separately in its statement of financial position. Thus, if the fair value calculation refers to a furnished office, as the leasing income relates to a furnished office, it will be necessary to adjust for the value of the furniture. In another example, the fair value of a leased investment property reflects the expected cash flows (including contingent rent that is expected to be paid). Accordingly, if a valuation obtained for the property is net of any expected payments, an entity shall add back any recognised liability for the lease, so as to arrive at a carrying amount for the investment property for accounting purposes (for more details regarding accounting for liabilities, see Section 10.3 below). Furthermore, an entity shall add income received in advance to the carrying amount of investment property calculated according to the present value of expected cash flows. In contrast, when, for example, dealing with elevators or air conditioning systems, there is no need for any adjustment, since - from an accounting point of view - these are usually an integral part of the overall building and thus constitute part of the economic value of the property.

6.5 Determining Fair Value for Property Interests under an Operating Lease

There may be circumstances where a reporting entity chooses to recognise in its financial statements a property interest under an operating lease, and will consequently be required to apply the fair value model, i.e., to measure this interest at fair value at each **reporting** date. In general, when dealing with leases priced at market conditions, the fair value of the interest at the time of acquisition must be zero (as expected lease payments reflect market prices by definition).

7. Reclassification of Investment Property

7.1 Eligible Transfers

Real estate properties may be transferred to or from three categories into which such properties are classified (inventories, owner-occupied property, and investment property) as follows: (a) transfer from investment property to owner-occupied property or to inventories; and (b) transfer from owner-occupied property or from inventories to investment property. According to the Standard, transfers to or from the investment property category should only be made when there is a change in use, evidenced by the following:

a. For transfers from investment property to owner-occupied property - commencement of owner occupation.
b. For transfers from investment property to inventories - commencement of development with a view to sale. This means that if, for example, a company decides to dispose of an investment property without development, the property should continue to be treated as investment property until its derecognition (rather than as inventory).
c. For transfers from owner-occupied property to investment property - end of owner occupation. Furthermore, it seems that owner-occupied property which has undergone renovation so as to become investment property should be classified as such only upon completion of the renovation.
d. For transfers from inventories to investment property - commencement of an operating lease to another party.

Thus, despite the initial classification of a property being based on management's intentions, future changes in classification are based strictly on actual changes and not on change in intentions. For example, a property company owns a well-established shopping mall. The fact that the company plans to sell the shopping mall will not change its classification as investment property unless it meets the criteria for classification as held for sale under IFRS 5. Furthermore, if a reporting entity plans to renovate a shopping mall prior to its sale, its plans will not change the shopping mall's classification as investment property. Only at the start of renovations will the shopping mall be reclassified from investment property to inventories. It should be noted that under a draft amendment issued by the IASB as part of its Annual Improvements to IFRSs project, if approved, it will no longer be possible to classify an investment property as inventory. Instead, the asset will continue to be measured according to the cost model or the fair value model as prescribed in the Standard.

There are cases where a property held for sale is classified as inventory but the reporting entity leases it out temporarily until a buyer is found. This raises the question - in light of the aforesaid in paragraph (d) above regarding reclassification from inventories into investment property at the commencement of an operating lease - of whether a temporary lease requires a property to be reclassified as investment property. It seems that as long as the lease is temporary and there is no change in management's intentions to sell the inventory during the ordinary course of business, there is no need to reclassify the asset as investment property, as leasing income is ancillary to the sale.

7.2 Accounting for Eligible Transfers

7.2.1 The cost model

When the cost model is applied, transfers between investment property, owner-occupied property and inventories change neither the carrying amount of the reclassified property nor its cost for measurement or disclosure purposes. Therefore, if a property treated as property, plant and equipment under the revaluation method prescribed in IAS 16 is reclassified as investment property, this does not affect the revaluation surplus accrued for the property. Although there is no reference to this in the Standard, it seems that the accrued revaluation surplus should be treated in accordance with IAS 16. This means that it is possible to transfer a pro rated share of the revaluation surplus, or its entire amount, directly into retained earnings at the rate of depreciation or upon disposal.

For circumstances where an eligible transfer is made during the reporting period, there is the question of whether the principles relevant to the previous classification should be applied until the very date of reclassification. Although there is no explicit reference to this issue in the Standard, it seems that proper accounting treatment requires that the previously relevant principles be applied until the date of transfer. For example, a company owns a leased office building which is classified as investment property. On May 1, 2008, the company vacates the building. Furthermore, on July 1, 2008, the company begins renovating the building with the aim of selling it during its ordinary course of business (reclassification as inventory). Proper accounting treatment demands that depreciation be made until the date of reclassification (i.e., July 1, 2008).

In another example, let us assume that a privately-held company (which only prepares annual statements) completes the construction of an apartment building for sale on December 31, 2007, at a total cost of CU 20 million, expecting to sell the apartments at a profit as of that date. Following a serious recession which occurs in the second quarter of 2008, resulting in a price drop for residential apartments for sale, the company decides, at the beginning of May 2008, to change the building's designation into rental apartments (net realisable value of inventory - CU 18 million). At the beginning of August 2008, the company begins leasing the apartments in the building (net realisable value of inventory - CU 15 million). It seems that at the date of reclassification from inventories into investment property (the beginning of August), the company should recognise a write-down for the inventory as per the guidance for measuring inventories, i.e. - CU 5 million (= 20,000,000 - 15,000,000). Therefore, the amount to be reclassified as investment property will total CU 15 million.

7.2.2 The fair value model

When the fair value model is adopted, a reclassification as investment property must be accounted for at fair value (accounting for the difference depends on the previous classification - see below). Reclassification from investment property into another category should be made using fair value as well.

The accounting treatment for each type of transfer is as follows:

A. Transfer from investment property presented at fair value to owner-occupied property or inventories

When reclassifying from investment property presented at fair value into owner-occupied property or inventories, the deemed cost of the property should be its fair value at the date of the change in use. Subsequent accounting treatment will be as prescribed under IAS 16 or IAS 2. In other words, until the date of reclassification, the property should be accounted for at fair value with changes in fair value being recognised in the statement of comprehensive income. Following the date of reclassification, the property should be accounted for according to the ordinary principles prescribed for property, plant and equipment or inventories, whichever applicable.

B. Transfer from owner-occupied property to investment property

When owner-occupied property is reclassified into investment property presented at fair value, an entity shall apply the provisions of IAS 16 until the date of the change in use. The resulting difference between the carrying amount of the property and its fair value, at this date, should be treated in the manner prescribed in IAS 16 for revaluation. Therefore, a decrease in the carrying amount of the property should be recognised in the statement of comprehensive income. However, to the extent that an amount is included in a revaluation surplus for this property, the decrease should be charged to the revaluation surplus. On the other hand, in the case of an increase in the carrying amount of the property, if the increase reverses previous impairment losses for this property, the increase should be recognised in the statement of comprehensive income. The amount recognised in the statement of comprehensive income should not exceed the amount necessary to recover the carrying amount that would have been determined, net of depreciation, had the impairment loss not been recognised. Subsequently, the remaining portion (or the whole) of the increase should be credited directly to other comprehensive income (revaluation surplus). Upon subsequent disposal of the investment property, the revaluation surplus, included under other comprehensive income, may be classified directly into retained earnings, i.e., not through the statement of comprehensive income.

C. Transfer from inventories to investment property

When reclassifying from inventories into investment property presented at fair value, any differences between the fair value of a property at that time and its carrying amount should be recognised in the statement of comprehensive income. The concept underlying this treatment is that it is consistent with the treatment for selling inventories. Although the Standard does not refer to the classification in the statement of comprehensive income of gains or losses incurred as a result of transfers , it seems that such gains or losses should be presented in a manner similar to profit or loss from the sale of inventory to third parties.

8. Derecognition

8.1 Guiding Principle

Investment property should be derecognised from the statement of financial position upon disposal or when it is permanently retired from active use and no future economic benefits are expected from its disposal. Investment property may be disposed of by selling or by a finance lease transaction. In order to determine the date of disposal, an entity shall apply the criteria for recognising income from the sale of goods prescribed under IAS 18 *Revenue*. As regards leases, an entity shall apply the principles prescribed under IAS 17.

8.2 Calculating Gains or Losses

Gains or losses resulting from the retirement or disposal of investment property should be determined as the difference between the net disposal proceeds and the carrying amount of a property, and should be recognised in the statement of comprehensive income in the period during which they were retired or disposed of (except in the cases of sale and leaseback where IAS 17 requires otherwise).

Although the Standard does not define what it means by "net proceeds", it seems that an entity shall rely on the provisions set forth under IAS 16. Accordingly, when determining net disposal proceeds, it seems that an entity shall include any direct and incremental costs resulting from disposal, such as: advertising, legal, brokerage, and evacuation costs. Furthermore, if, under a sale agreement, a company incurs provisions upon derecognizing an asset, for example, a provision for repairs or for claims against the asset in connection with the period in which it was owned by the seller, it seems that these provisions shall be offset against the property's net disposal proceeds.

When calculating gains, the consideration from the property's disposal should be initially recognised at fair value. Therefore, if payment is made by way of credit, initial recognition of the consideration should be according to its cash price equivalent. The difference between the nominal amount of the consideration and its cash price equivalent should be recognised as interest income in accordance with IAS 18, which reflects the effective return for the outstanding amount receivable. It seems that, usually, there should not be any significant differences between this determination and the determination under IAS 39 *Financial Instruments: Recognition and Measurement,* as regards the principles for measuring accounts receivable upon initial recognition (that require measurement according to present value at market interest rates). However, if such a difference exists, it seems that the provisions of IAS 40 should be applied, as these provisions are more specific.

Compensation from third parties for investment property that was impaired or waived, should be included in the statement of comprehensive income when it becomes receivable. Furthermore, in this case, the compensation received may be offset against losses incurred from the investment property in the statement of comprehensive income.

8.3 Replacement of Part of an Investment Property

If, according to the principle for recognising investment property, a reporting entity capitalises the cost of a replacement for part of an investment property as part of the carrying amount of the asset, it derecognises the carrying amount of the replaced part. Regarding investment property treated using the cost model, a replaced part may not be a part that was depreciated separately. If it is not practical to determine the carrying amount of the replaced part, it is possible to use the replacement cost as an indication for the cost of the replaced part at the date of acquisition or construction.

Under the fair value model, the fair value of an investment property may already reflect a loss of value of the part being replaced. In other cases, it may be difficult to distinguish the amount by which the fair value is to be reduced for the replaced part. An alternative to reducing fair value for the replaced part, when this course of action is impracticable, is to include the replacement cost in the carrying amount of the asset, and then to re-estimate the fair value, as required for non-replacement additions. For example, a company which has adopted the fair value model carries out a massive renovation of an investment property which includes the replacement of items so that the property may continue to serve as an investment property. According to the Standard, the company shall continue to classify the property as investment property, i.e., continue to measure it at fair value (in contrast, as aforesaid, to a situation where the renovation is carried out from the start). In this case, in light of a possible lack of information enabling the reporting entity to treat the derecognition of each item separately, it seems that the reporting entity can account for the derecognitions as part of the change in fair value.

8.4 Restoration or Construction in lieu of Derecognition

Restoration, acquisition or construction of assets in lieu of derecognised investment property constitutes a separate economic event. Therefore, it must be accounted for as at the initial recognition of investment property.

9. Presentation and Disclosure

9.1 Presentation

Investment property is presented separately in the statement of financial position. The requirement for separate presentation also applies when the investment property is measured using the cost model. It should be noted that a reporting entity may also include investment property under construction or development under its investment property line item, whether it is measured at fair value or at cost due to the lack of a reliable fair value estimate.

9.2 Disclosure Requirements

9.2.1 General

The Standard includes general disclosure requirements as well as additional disclosure requirements as per the model applied in measuring the investment property: the fair value model or the cost model. It should be noted that the Standard does not refer to disclosure for separate investment property assets or certain categories of investment property, and apparently one could conclude that the disclosure requirements may refer to all investment property uniformly. However, it seems that in order to provide useful information to the various users of an entity's financial statements, an entity shall include certain categories in order to distinguish between different types of investment property. For example, distinction according to the present condition of an investment property (e.g., between investment property under development and vacant investment property), or distinction according to types of usage (e.g., residential, office use, commercial).

It should be noted that, in addition to the above disclosure requirements, there are additional disclosure requirements prescribed under IAS 17 and IFRS 7 *Financial Instruments: Disclosures* regarding finance or operating leases related to investment property. Furthermore, pursuant to IAS 1 *Presentation of Financial Statements*, reporting entities are required to provide disclosure regarding uncertainty factors in estimates, including information regarding the sensitivity of the carrying amounts to the underlying methods, assumptions and estimates used for their calculation, including the causes for this sensitivity.

9.2.2. General disclosure requirements

A. The applied model - the fair value model or the cost model.
B. If the fair value model is applied – whether, and under what circumstances, are property interests held under an operating lease classified and accounted for as investment property.
C. When it is difficult to classify and determine whether or not a property is eligible as investment property - the criteria used by the reporting entity to distinguish between investment property, owner-occupied property, and property held for sale during the ordinary course of business.
D. The methods and significant assumptions used in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or relied more on other factors (which must be disclosed by the reporting entity) due to the nature of the property and lack of comparable market data.
E. The extent to which the fair value of an investment property (as measured or for which disclosure was made in the financial statements) relies on a valuation conducted by an independent valuer who holds a recognised and relevant professional qualification and has current experience regarding the location and type of investment property being valued. If no such valuation took place, this fact must be disclosed.
F. The amounts recognised in the statement of comprehensive income for:
   (1) Rental income from investment property,
   (2) Direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period,
   (3) Direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period; and
   (4) The cumulative change in fair value recognised in the statement of comprehensive income on the sale of an investment property from a pool of assets for which the cost model was employed to a pool of assets for which the fair value model was employed.
G. The existence and scope of restrictions on the realisability of investment property or on the transfer of income and proceeds from disposal, and
H. Contractual obligations to purchase, construct or develop investment property or to carry out repairs, maintenance or enhancements.

9.2.3 The fair value model

When the fair value model is applied, in addition to the general disclosure requirements, disclosure must be made regarding the reconciliation between the carrying amounts of investment property at the beginning and end of the period, which should include the following details:
A. Additions, with separate disclosure for additions resulting from acquisitions and additions due to subsequent expenditures recognised in the carrying amount of the asset;
B. Additions due to acquisitions by way of business combinations;
C. Assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;

D. Net gains or losses from adjustments to fair value;
E. Net exchange differences due to the translation of the financial statements into another presentation currency, and to the translation of foreign operations into the reporting entity's presentation currency;
F. Transfers to and from inventories and owner-occupied property; and
G. Other changes.

Furthermore, when a valuation obtained for an investment property is adjusted significantly in the preparation of the financial statements, for example, in order to avoid double counting of assets and liabilities which are recognised as separate assets and liabilities, an entity shall disclose a reconciliation between the valuation and the adjusted valuation included in the financial statements, showing separately the aggregate amount of any recognised lease obligations that have been added back, and any other significant adjustments.

It should be noted that in exceptional cases where investment property is measured using the cost model prescribed under IAS 16 due to inability to reliably determine fair value, the required reconciliation should include disclosure regarding the amounts related to such investment property separately from amounts related to other investment property. Furthermore, an entity should disclose:
A. A description of the investment property;
B. An explanation of why fair value cannot be determined reliably;
C. If possible, the range of estimates in which fair value is highly likely to be found; and
D. Upon disposal of investment property not carried at fair value, disclosure must be made of the fact that the reporting entity has disposed of investment property which was not carried at fair value, of the carrying amount of such investment property at the date of sale, and of the amount of gain or loss recognised.

9.2.4 The cost model

When the cost model is applied, in addition to the general disclosure requirements, the entity should disclose:
A. The depreciation methods applied;
B. The useful life or the depreciation rates used;
C. The gross carrying amount and accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;
D. Reconciliation between the carrying amount of investment property at the beginning and end of the period, which includes the following details:
   1. Additions, with separate disclosure for additions due to acquisitions and additions due to subsequent expenditure recognised as an asset;
   2. Additions due to acquisitions by way of business combinations;
   3. Assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;
   4. Depreciation;
   5. The amount of recognised impairment losses and the amount of impairment losses reversed during the period, in accordance with IAS 36 *Impairment of Assets*;
   6. Net exchange differences due to the translation of the financial statements to a different presentation currency and to translation of a foreign operation into the reporting entity's presentation currency;
   7. Transfers to and from inventories and owner-occupied property; and
   8. Other changes.

E. The fair value of the investment property. In exceptional cases, where it is impossible to reliably determine the fair value of an investment property, the following disclosures must be made: a description of the investment property; an explanation as to why it is impossible to reliably determine fair value; and, to the extent possible, the range of estimates in which the fair value is highly likely to be found.

10. Interactions of IAS 40 with Other Standards

10.1 Accounting for Incentives to Lessees

Occasionally, when a reporting entity leases an investment property under an operating lease, it may provide the lessee with various incentives, such as a rent-free or reduced rent period. SIC-15 Operating Leases - Incentives (SIC-15) states that the lessor should recognise the cost of the incentives as a reduction of rental income over the lease term (usually according to the straight-line method). However, for investment property measured at fair value, the incentives provided to the lessee are already included in the measurement of the income-producing property's fair value. Accordingly, recognition of a separate asset in respect of the incentives granted, which is amortized over the lease term, would lead to double counting of the benefit.

In this case, it seems that, in accordance with IAS 40, the property should be presented at its fair value, taking into consideration the various incentives granted to lessees. Furthermore, the incentives granted to the lessees will affect the rental income recognised in the statement of comprehensive income, and so the lessor should recognise the rental income according to the straight-line method over the lease term, while taking into consideration the various incentives granted to the lessees (rent averaging). Alternatively, the lessor may recognise the incentive granted to the lessees as a separate asset (rent averaging). However, in this case, the carrying amount of the investment property should be reduced, so as to avoid double counting.

Example
On January 1, 2008, a company signs a 10-year operating lease with a lessee. Under the agreement, annual rent amounts to CU 100,000 per year, to be paid beginning from the third year onwards (i.e., the first two years are rent-free). Rent is paid at the beginning of each year. The fair value of the investment property on January 1, 2008 is CU 1,000,000, which reflects a return rate of 8% = 1,000,000 / (100,000 X 8/10) . Furthermore, the investment property's fair value on December 31, 2008 is CU 1,050,000. It should be assumed that the property's fair value takes into account the rent-free period.

In 2008, no rent is paid for the property. However, in accordance with the provisions of SIC-15, the company is required to average the total rent over the lease term. Accordingly, the company shall recognise rent in the amount of CU 80,000 (= 100,000 X 8/10). Furthermore, the investment property shall be presented as at December 31, 2008 at fair value, i.e. - CU 1,050,000.
Accordingly, the journal entry recorded in 2008 will read (in CU):

Dr	Investment property	1,050,000 - 1,000,000 =	50,000	
Dr	Impairment of investment property	(1,050,000-1,000,000)-80,000 =	30,000	
	Cr Rental income			80,000

Alternatively, the company can present the incentive granted to the lessee as a separate asset. Accordingly, the company must reduce the investment property's value in order to avoid double counting.

Accordingly, the journal entry recorded in 2008 will read (in CU):

Dr	Other receivables - incentives	100,000 X 8/10 - 0 =			80,000
Dr	Impairment of investment property			30,000	
	Cr Rental income			80,000	
	Cr Investment property	(1,050,000-1,000,000)-80,000=	30,000		

10.2 Capitalisation of Financing for Investment Property under Construction

According to IAS 23 *Borrowing Costs,* a reporting entity is not obligated to apply its provisions to assets measured using the fair value model, such as investment property. However, pursuant to IAS 23, it is possible to account for borrowing costs for assets measured at fair value as though these have been capitalised. Thus, it seems that it is possible to account for borrowing costs attributed to investment property under construction under the line item presenting revaluations to fair value, instead of classifying them under financing expenses. For example, a real estate company constructs a shopping mall which meets the definition of investment property under construction. The company chooses to measure the property at fair value. The company may account for borrowing costs it has incurred for the construction of the shopping mall as though these were capitalised as part of the asset under construction, and so present measurement differences under the line item which includes the fair value revaluations (appreciation of investment property) instead of under the financing expenses line item. Such accounting treatment may influence the covenants and/or other criteria used to compare between different reporting entities, such as FFO (Funds From Operations).

10.3 Fair Value of Investment Property under an Operating Lease

The Standard allows reporting entities to classify and account for property interests held under an operating lease as investment property if, and only if, such a property would otherwise meet the definition of investment property and the reporting entity applies the fair value model. In such a case, the lessee should, in effect, account for the lease as a finance lease. Thus, if the lease payments are paid (in whole or in part) on an ongoing basis, the reporting entity must, at the

commencement of the lease term, recognise an asset (investment property) and a liability (payable lease payments) according to the asset's fair value or the present value of the minimum lease payments, the lower of the two. In subsequent periods, the liability for the lease payments should be measured according to its amortised cost using the discount rate implicit in the transaction. On the other hand, the investment property interests should be measured at fair value, and in most cases, this fair value already takes into account the present value of the future lease payments payable by the reporting entity, with this amount being discounted using the discount rate common at the time of valuation, and not the original discount rate. However, for the purpose of the financial statements, the Standard states that the reporting entity shall add back the liability recognised for the lease in order to arrive at the fair value of the investment property.

This raises the question of how the reporting entity should account for subsequent changes in the fair value of its investment property interests. In other words, is the carrying amount of the property to be calculated while adding back the fair value of the liability or, alternatively, should the reporting entity add the amortised cost of the liability as included in the financial statements. In the past, both methods were acceptable. However, in 2008, the Standard was amended so that reporting entities are required to add back the carrying amount of the liability, so that the carrying amount of the investment property net of the liability for future lease payments should be equal to the net fair value of the investment property interests at that time.

Example
On January 1, 2008, a company enters into an operating lease with a third party, for a period of 20 years, for the lease of land and a building. It is assumed that the company classifies its interests in the land and in the building as investment property, and so applies the fair value model prescribed under the Standard. Lease payments in the amount of CU 20,000 are paid annually at the end of each year. The present value of the minimum lease payments is CU 196,363, calculated using an annual discount rate of 8%.

On December 31, 2008, the fair value of the investment property interests (net) was estimated to be CU 99,590, with this amount including the present value of expected lease income in the amount of CU 298,772 less a liability to pay minimum lease payments of CU 199,182. This amount was calculated using a discount rate of 7.5%. The carrying amount of the liability for the minimum lease payments for the remainder of the period (19 years), calculated using the original discount rate (8%) is CU 192,072. According to the Standard, the company shall measure in its statement of financial position a liability for the minimum lease payments in the amount of CU 192,072 and the investment property in the amount of CU 291,662 (= 99,590 + 192,072). As can be seen, this amount differs from the present value of the expected lease income (CU 298,772).

10.4 Investment Property Classified as Held for Sale

IFRS 5 states that investment property measured at fair value is not subject to the measurement provisions of IFRS 5. Instead, the income-generating asset should continue to be measured at fair value until it is derecognised, with changes recognised in the statement of comprehensive income. However, such investment property is subject to the classification and presentation requirements prescribed in IFRS 5. Therefore, investment property which meets the classification criteria set forth in IFRS 5 as being held for sale should be presented as a separate line item in the statement of financial position, as part of the assets held for sale.

However, investment property measured according to the cost model and which meets the definition of a held-for-sale asset is furthermore subject to the measurement requirements set forth under IFRS 5. Accordingly, a reporting entity shall cease to recognise depreciation expenses for such an asset at the time of its classification as being held for sale, and shall furthermore measure the property at the lower of its carrying amount and its fair value net of costs to sell.

It should be noted that if investment property meets the definition of a discontinued operation, it must be accounted for in accordance with IFRS 5, including the separate presentation of net profit or loss for the discontinued operation, including reclassification of comparative figures.

For more detailed explanations, see also Volume A, Chapter 8 - Assets Held for Sale and Discontinued Operations.

10.5 Accounting for Deferred Taxes for Investment Property Measured according to the Fair Value Model

IAS 12 *Income Taxes* requires that the measurement of deferred tax assets and deferred tax liabilities reflect the tax consequences arising from the manner in which the reporting entity expects to recover or settle the carrying amount of these assets and liabilities. Moreover, SIC 21 *Income Taxes - Recovery of Revalued Non-Depreciable Assets* requires that deferred tax assets or liabilities for revalued assets be measured taking into account the tax implications arising from the recovery of an asset through its sale. Therefore, for non-depreciable assets, if the tax rate that applies to the sale of an asset differs from the tax rate that applies to the use of the asset, then the tax rate for the sale of the asset is to be used.

However, SIC 21 states that it applies to investment property measured at fair value to the extent that it would have been considered a non-depreciable asset had the provisions of IAS 16 been applied. Moreover, the fact that the investment property is not depreciated in the financial statements does not indicate that the asset is non-depreciable in nature, and so deferred taxes should only be measured for the asset according to the tax rate applicable to its sale. Therefore, it seems that, for the purpose of calculating deferred taxes, investment property must be separated into its land and building components. For the land component, deferred taxes should be calculated as per the tax rate applicable on sale. However,

as for the building component, the part attributed to the economic depreciation of an asset should be calculated as per the tax rate applicable to the use of the asset, while the tax rate applicable on sale should be used for the residual value.

10.6 Tax Rates Applicable to Single-Asset Entities

Many real estate companies commonly hold real estate assets through direct holdings in a single-asset entity and, in many cases, the entire operation of the single-asset entity amounts to holding the income-generating asset. Thus, though the company invests in the asset through holding the shares of the single-asset entity, its investment is strictly passive for the purpose of receiving lease income. In other words, it may be said that single-asset entities are to be regarded as an investment which is equivalent in nature to a direct investment in the real estate asset. There are many reasons for such a mechanism, including tax considerations, as some countries, such as Germany and Russia, apply a significantly lower tax rate to the sale of shares than to the sale of the asset.

However, IAS 12 requires that when measuring deferred tax liabilities and deferred tax assets, the consequences of the manner in which the reporting entity expects to recover or settle the carrying amount of its assets and liabilities be reflected as at the **reporting** date. Therefore, a literal interpretation of IAS 12 would lead to the conclusion that deferred taxes cannot be measured according to the tax rate applicable to the sale of the shares. Despite the aforesaid, it may be argued that in specific cases where the reporting entity has proven that it expects to recover or settle an asset or liability through the sale of shares, deferred taxes may be measured according to the tax rate applicable to the sale of such shares. Furthermore, in this case, it seems that the income-generating asset's fair value should be decreased so as to reflect the tax which market participants would have paid for the sale of the income-generating asset.

It should be noted that if the single-asset company constitutes a "business" as defined in IFRS 3 *Business Combinations*, it cannot be argued that the reporting entity's holdings in the single-asset entity is equivalent in nature to holding the asset, and so the reporting entity shall measure deferred taxes as per the tax rate applicable to the sale of the asset, and not to the sale of the shares.

10.7 Testing for Impairment of Goodwill in Income-Generating Property Entities

May entities holding a portfolio of investment property measured at fair value recognise goodwill in their statement of financial position? This question arises in light of the fact that testing for impairment of a cash generating unit containing goodwill is, in this case, carried out by discounting future cash flows, with such cash flows already factored into the fair value of the investment property assets.

In this regard, it should be noted that, as part of a purchase price allocation in a business combination, a reporting entity recognises a deferred tax liability according to the difference between the fair value of the investment property and its tax base, multiplied by the applicable tax rate. Pursuant to IAS 12, the deferred tax liability is recognised at full value regardless of its economic value, which, in many cases, may be significantly lower than its carrying amount due to various tax planning strategies, sometimes even to the point of being negligible in value. In other words, although the acquisition price actually reflects a significantly lower value for a deferred tax liability, accounting principles require that the reporting entity recognise the liability at its full value, regardless, as aforesaid, of the likelihood and/or timing of the expected payment. Consequently, the amount of goodwill recognised in the acquirer's statement of financial position will likewise be inflated in the amount of the difference between the economic value of the deferred tax liability and its carrying amount.

For example, Company A acquires 100% of the shares of Company B. For the sake of this example, it should be assumed that Company B's only asset is an investment property (shopping mall) with a fair value of CU 1 million, while its tax base is CU 400,000. Furthermore, it should be assumed that the acquisition constitutes a business combination and that the applicable tax rate is 25%. The cost of the acquisition totals CU 1 million, as the economic value of the tax liability is negligible. In this case, Company A should recognise in its financial statements goodwill in the amount of CU 150,000 = 1,000,000 - (1,000,000 - 600,000 X 25%), which arises solely on the recognition of a deferred tax liability at full value, which is CU 150,0000 = (1,000,000 - 400,000) X 25%, despite its economic value being zero in this case.

The provisions of IAS 36 specifically require that expected tax implications not be taken into account when estimating expected cash flows. Therefore, literal application of IAS 36 would have resulted in an immediate recognition of impairment loss for goodwill, which in the above example amounts to CU 150,000. However, it seems that a proper interpretation, in this case, would be to test goodwill for impairment while taking into account the economic value of the deferred tax liability. In other words, in order to test for the impairment of goodwill, an entity shall offset the difference between the carrying amount of the deferred tax liability and its economic value against its carrying amount. Thus, in the above example, the amount of goodwill which would have been tested for impairment is CU 0 = (1,000,000 - 400,000) X 25% - 150,000. It should be noted that this method is also to be applied when testing for impairment of goodwill in subsequent periods. To this end, the reporting entity should be required to monitor the amount of the deferred tax liability, and if the amount of the liability decreases or is settled, for example - following impairment of an investment property or due to changes in applicable tax policies, goodwill recognised at the time of a business combination may become impaired.

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