

Applying IFRS for the real estate industry

May 2023



Real estate

This publication considers the main accounting issues encountered by real estate entities and the practices adopted in the industry under International Financial Reporting Standards (IFRS). It covers issues that we believe are of financial reporting interest due to their particular relevance to real estate entities and/or historical varying international practice.



Links to IFRS Standards and PwC Manual of Accounting (Standing text, FAQ & EX) work only for Viewpoint subscribers.

Applying IFRS for the real estate industry

What is the focus of this publication?

This publication considers the main accounting issues encountered by real estate entities and the practices adopted in the industry under International Financial Reporting Standards (IFRS).

Who should use this publication?

This publication is intended for entities that construct and manage real estate property. Activities such as the construction of properties on behalf of third parties, and holding or developing properties principally for sale or otherwise own use, are not considered in this publication.

This publication is intended for:

- audit committees, executives and financial managers in the real estate industry;
- investors and other users of real estate industry financial statements, so that they can identify some of the accounting practices adopted to reflect features unique to the industry; and
- accounting bodies, standard-setting agencies and governments throughout the world that are interested in accounting and reporting practices and are responsible for establishing financial reporting requirements.

What is included?

This publication covers issues that we believe are of financial reporting interest due to their particular relevance to real estate entities and/or historical varying international practice.

This publication has a number of sections designed to cover the main issues raised.

This publication is based on the experience gained from the worldwide leadership position of PwC in the provision of services to the real estate industry. This leadership enables PwC's Real Estate Industry Accounting Group to make recommendations and lead discussions on international standards and practice.

We hope you find this publication helpful.

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1. Real estate value chain

1.1. Overview of the investment property industry

The investment property or real estate industry comprises entities that hold real estate (land and buildings) to earn rentals and/or for capital appreciation.

Real estate properties are usually held through a variety of structures that include listed and privately held corporations, investment funds, partnerships and trusts.

1.2. Real estate life cycle

The life cycle of real estate that is accounted for as investment property typically includes the following stages:



1.2.1. Step 1: Acquisition or construction of real estate

Step 1: Acquisition or construction of real estate

Control of real estate can be obtained through:

- direct acquisition of real estate;
- construction of real estate;
- leasing of real estate; or
- a combination of the above.

Entities normally perform strategic planning before the acquisition, construction or leasing, to assess the feasibility of the project.

Entities might incur costs attributable to the acquisition, construction or leasing of real estate during this first step of the cycle. Entities might also enter into financing arrangements to secure the liquidity required for the acquisition or construction of real estate.

1.2.2. Step 2: Leasing or subleasing of real estate

Step 2: Leasing or subleasing of real estate

Most real estate entities primarily hold real estate for the purpose of earning rentals. They may also hold some real estate for their own use.

For entities holding real estate for the purpose of earning rentals, lease agreements might contain a variety of terms. The most common terms that will feature in all leases include matters such as the agreed lease term (and any options to extend that term), as well as the agreed rental payments due. Additional items that might feature include payments for maintenance services, utilities, insurance, property taxes and terms of lease incentives provided to the tenant.

1.2.3. Step 3: Management of real estate

Step 3: Management of real estate

Real estate entities often provide management services to tenants who occupy the real estate that they hold, to ensure that the property is in good condition and to preserve the value of the real estate. These services might be performed by the real estate owners themselves, or they might be outsourced to other entities that are designed to provide these services. Services might include maintenance of common areas, cleaning and security.

1.2.4. Step 4: Sale or demolition of real estate

Step 4: Sale or demolition of real estate

Real estate entities might sell the real estate that they hold at the end of the life cycle to benefit from capital appreciation. Alternatively, entities might proceed with demolition of the property, potentially with a view to construction of a new property.

1.3. Relevant accounting standards

The acquisition and construction of real estate that is accounted for as investment property are governed by the requirements of IAS 40, 'Investment property', IAS 16, 'Property, plant and equipment', and IAS 23, 'Borrowing costs'.

The requirements of IFRS 16, 'Leases', apply to both arrangements where an entity leases out real estate property and real estate properties held under leases as a lessee.

The requirements of IFRS 15, 'Revenue from contracts with customers', apply to revenue generated by a real estate entity for the provision of services to tenants, which are separated from that portion of income that relates to the leased asset accounted for under IFRS 16.

The requirements of IFRS 9, 'Financial Instruments', apply to financial assets and liabilities recognised by real estate entities.

This publication is based on accounting standards that are effective for annual periods beginning on or after 1 January 2022.

There are a number of new pronouncements, issued as of the date of this publication, that are not yet effective. Their impact, where relevant, is presented in separate sections under each related area or otherwise referred to specifically in the guide. These pronouncements are as follows:

- IFRS 17, 'Insurance Contracts', which replaces IFRS 4 ('IFRS 17') (effective 1 January 2023);
- Amendments to IAS 1, 'Presentation of financial statements' and IFRS Practice Statement 2 'Making materiality judgements', on the disclosure of accounting policies (effective 1 January 2023);
- Amendments to IAS 8, 'Accounting Policies, changes in accounting estimates and errors', on the definition of accounting estimates (effective 1 January 2023);
- Amendments to IAS 12, 'Income taxes' and IFRS 1, 'First-time adoption of International Financial Reporting Standards', on deferred taxes related to assets and liabilities arising from a single transaction (effective 1 January 2023);
- Amendments to IAS 1, 'Presentation of financial statements', on classification of liabilities as current or non-current and non-current liabilities with covenants (effective 1 January 2024); and
- Amendments to IFRS 16 'Leases', on lease liabilities in a sale and leaseback (effective 1 January 2024).

The following standards and interpretations, effective as at the date of this publication, are referred to in the guide:

- IFRS 3, 'Business combinations' ('IFRS 3');
- IFRS 5, 'Non-current assets held for sale and discontinued operations' ('IFRS 5');
- IFRS 7, 'Financial instruments: disclosures' ('IFRS 7');
- IFRS 8, 'Operating segments' ('IFRS 8');
- IFRS 9, 'Financial Instruments' ('IFRS 9');
- IFRS 10, 'Consolidated financial statements' ('IFRS 10');
- IFRS 11, 'Joint arrangements' ('IFRS 11');
- IFRS 13, 'Fair value measurement' ('IFRS 13');
- IFRS 15, 'Revenue from contracts with customers' ('IFRS 15');
- IFRS 16, 'Leases' ('IFRS 16');
- IAS 1, 'Presentation of financial statements' ('IAS 1');
- IAS 2, 'Inventories' ('IAS 2');
- IAS 7, 'Statement of cash flows' ('IAS 7');
- IAS 8, 'Accounting policies, changes in accounting estimates and errors' ('IAS 8');

- IAS 12, 'Income taxes' ('IAS 12');
- IAS 16, 'Property, plant and equipment' ('IAS 16');
- IAS 21, 'The effects of changes in foreign exchange rates' ('IAS 21');
- IAS 23, 'Borrowing costs' ('IAS 23');
- IAS 27, 'Separate financial statements' ('IAS 27');
- IAS 28, 'Investments in associates and joint ventures' ('IAS 28');
- IAS 36, 'Impairment of assets' ('IAS 36');
- IAS 37, 'Provisions, contingent liabilities and contingent assets' ('IAS 37');
- IAS 38, 'Intangible assets' ('IAS 38');
- IAS 40, 'Investment property' ('IAS 40');
- IFRIC 22, 'Foreign currency transactions and advance consideration' ('IFRIC 22'); and
- IFRIC 23, 'Uncertainty over income tax treatments' ('IFRIC 23').

2. Acquisition or construction of real estate

2.1. Overview

Real estate entities obtain real estate either by acquiring, constructing or leasing property. Property used for the purpose of earning rentals or held for capital appreciation is classified as investment property under IAS 40.

2.2. Definition and classification

2.2.1. Principles

IAS 40 defines investment property as property that is held to earn rentals or capital appreciation, or both. [IAS 40 para 5]. The property might be land or a building (or part of a building), or both. Further guidance on scope and classification can be found in the [PwC Manual of Accounting chapter 23 paragraphs 1–15](#).

Investment property does not include the following:

- Property intended for sale in the ordinary course of business or for development and resale.
- Owner-occupied property, including property held for such use or for redevelopment prior to such use, and property occupied by employees.
- Owner-occupied property awaiting disposal.
- Property that is leased to another entity under a finance lease.

[IAS 40 para 9].

Owner-occupied property is property that is used in the production or supply of goods or services or for administrative purposes. [IAS 40 para 5]. A factory or the corporate headquarters of an entity would qualify as owner-occupied property. During the life cycle of a property, real estate entities might choose to redevelop property for the purposes of onward sale. Property held for sale in the ordinary course of business is classified as inventory rather than investment property. [IAS 40 para 9(a)]. Transfers between investment property and both owner-occupied property and inventory are dealt with in [section 3.7](#).

Classification as investment property is not always straightforward. Factors to consider, when determining the classification of a property, include but are not limited to:

- the extent of ancillary services provided ([see section 2.2.2](#));
- the extent of use of the property in running an underlying business;
- whether the property has dual use ([see section 2.2.6](#));
- the strategic plans of the entity for the property; and
- previous use of the property.

Example – Property leased out to hotel management entity
Reference to standard: IAS 40 para 9 Reference to standing text: 23.10 Industry: Real Estate
Background Entity A owns property which it leases out under an operating lease to a hotel management entity. Entity A has no involvement in the running of the hotel or any decisions made; these decisions are all undertaken by the hotel management entity, which also bears the operating risk of the hotel business. Does the property meet the definition of ‘investment property’ for entity A?

Solution

Yes. Although the property is used as a hotel by the lessee, entity A uses the property to earn rentals, and so the property meets the definition of 'investment property'.

Example – Hotel management contract**Background**

Entity A owns property that is operated as a hotel. The entity signed a contract with a hotel management entity. Entity A has no involvement in the running of the hotel or any day-to-day operating decisions made; these decisions have all been delegated to the hotel management entity which receives a fixed management fee. However, the operating risk of the hotel business remains with entity A, because the returns received by entity A include all of the variability of the performance of the hotel.

Does the property meet the definition of 'investment property' for entity A?

Solution

No. Although the management entity operates the property as a hotel, entity A bears the operational risk of the hotel business and, thus, the contract with the hotel management entity is a management contract rather than a lease contract. The property is classified as property, plant and equipment in the financial statements of entity A.

Where an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property. [IAS 40 para 58]. The property will continue to be classified as investment property until it meets the criteria to be classified as a non-current asset held for sale in accordance with IFRS 5 (see section 6).

2.2.2. Ancillary services

Where an entity provides insignificant ancillary services, such as maintenance, to the third party occupants of the property, this does not affect the classification of the property as an investment property. [IAS 40 para 11].

Where ancillary services provided are more than insignificant, the property is regarded as owner-occupied, because it is being used, to a significant extent, for the supply of goods and services. For example, in a hotel, significant ancillary services (such as a restaurant, fitness facilities or spa) are often provided. IAS 40 provides no application guidance as to what 'insignificant' means. Accordingly, entities should consider both qualitative and quantitative factors in determining whether services are insignificant. Further guidance on Ancillary services can be found in the [PwC Manual of Accounting chapter 23 paragraphs 16–18](#).

Example – Serviced apartments

Reference to standard: IAS 40 para 11

Reference to standing text: 23.16

Industry: Real Estate

Background

An entity owns a number of apartments which it leases out to tenants under short-term leases. The entity is also responsible for providing in-house cleaning services, and it undertakes to provide internet, telephone and cable television to the tenants for an additional monthly fee. The additional fee charged for the services is approximately 20% of the total monthly rental.

Does the property meet the definition of 'investment property'?

Solution

No. The entity provides ancillary services to the tenants other than the right to use the property. The value of these services represents around 20% of the income earned from the tenants. Therefore, these services cannot be viewed as insignificant. The property is classified as property, plant and equipment in the financial statements of the entity.

2.2.3. Properties under construction or development

Real estate that meets the definition of 'investment property' is accounted for in accordance with IAS 40, even during the period when it is under construction. Further, an investment property under redevelopment for continued future use as investment property also continues to be recognised as investment property.

2.2.4. Properties held to be leased out as investment property

Real estate entities might hold investment properties that are vacant for a period of time. Where these properties are held to be leased out under an operating lease, they are classified as investment property.

2.2.5. Properties with undetermined use

Land with undetermined use is accounted for as investment property. This is due to the fact that an entity's decision around how it might use that land (be it as an investment property, inventory or as owner-occupied property) is, of itself, an investment decision. In turn, the most appropriate classification for such property is as investment property. [IAS 40 para 8(b)].

2.2.6. Properties with dual use

A property might be partially owner-occupied, with the rest being held for rental income or capital appreciation.

If each of these portions can be sold separately (or separately leased out under a finance lease), the entity should account for the portions separately. [IAS 40 para 10]. That is, the portion that is owner-occupied is accounted for under IAS 16, and the portion that is held for rental income or capital appreciation, or both, is treated as investment property under IAS 40.

If the portions cannot be sold or leased out separately under a finance lease, the property is investment property only if an insignificant portion is owner-occupied, in which case the entire property is accounted for as investment property. If more than an insignificant portion is owner-occupied, the entire property is accounted for as property, plant and equipment. There is no guidance under the standards as to what 'insignificant' means; accordingly, entities should consider both qualitative and quantitative factors in determining whether the portion of the property is insignificant.

Example – Hotel resort with a casino
<p>Reference to standard: IAS 40 para 10 Reference to standing text: 23.16 – 23.18 Industry: Real Estate</p>
<p>Background Entity A owns a hotel resort which includes a casino, housed in a separate building.</p> <p>The entity operates the hotel and other facilities on the hotel resort, with the exception of the casino, which can be sold or leased out under a finance lease. The casino is leased to an independent operator. Entity A has no further involvement in the casino. The casino operator will only operate the casino with the existence of the hotel and other facilities.</p> <p>Does the casino meet the definition of 'investment property'?</p>
<p>Solution Yes. Management should classify the casino as investment property. The casino can be sold separately or leased out under a finance lease. The hotel and other facilities would be classified as property, plant and equipment.</p> <p>If the casino could not be sold or leased out separately on a finance lease, the whole property would be treated as property, plant and equipment.</p>

2.2.7. Group situations

Within a group of entities, one group entity might lease property to another group entity for its occupation and use.

In the consolidated financial statements, such property is not treated as investment property; this is because, from the group's point of view, the property is owner-occupied. In the separate financial statements of the entity that owns the property or holds it under a lease, the property will be treated as investment property if it meets the definition in paragraph 5 of IAS 40. [IAS 40 para 15].

In contrast, property owned or held under a lease by a group entity and leased to an associate or a joint venture should be accounted for as investment property in both the consolidated financial statements and any separate financial statements prepared. Associates and joint ventures are not considered part of the group for consolidation purposes. Further guidance on group considerations can be found in the PwC Manual of Accounting chapter 23 paragraphs 19–20.

2.2.8. Properties held under leases

Under IFRS 16, almost all leases must be brought on the balance sheet of the lessee. The lessee recognises a right-of-use asset and a corresponding liability at the lease commencement date. [IFRS 16 para 22]. Further guidance on lease recognition for leases of investment property can be found in the [PwC Manual of Accounting chapter 23 paragraph 36](#).

Real estate entities often hold investment properties that are located on leased land, and these ground leases are often for long periods of time (for example, 99 years). These entities are lessees in respect of the ground lease and, under IFRS 16, they must recognise a right-of-use asset and lease liability in relation to these leases. In turn, the right-of-use asset is classified as an investment property, given that the leased land is held solely for the purposes of holding the related investment property building. Further, where the real estate entity applies the fair value model for its investment property, it will equally be required to apply this model to right-of-use assets that meet the definition of investment property. [IFRS 16 para 34].

The right-of-use asset is measured on initial recognition in accordance with IFRS 16. [IAS 40 para 29A]. IFRS 16 requires a right-of-use asset to be measured at the amount of the initial measurement of the lease liability, adjusted for any lease payments made at or before the commencement date and any lease incentives received. Any initial direct costs incurred by the lessee and the estimated costs of decommissioning or restoration obligations required by the lease are also added to the right-of-use asset. Where a ground lease is negotiated at market rates, the fair value of the right-of-use asset, net of the market rents promised under the lease and the expected outflows for any decommissioning or restoration obligations, should be zero. [IAS 40 para 41]. It follows that the fair value of a newly negotiated ground lease at market rents should differ from the net of the initial recognition amounts only in respect of any initial direct costs incurred by the lessee, since transaction costs are not included in a fair value calculation in accordance with IFRS 13. Similarly, a lease interest purchased in an arm's length transaction (other than in a business combination) would be expected to have a fair value equal to the purchase consideration paid (that is, the cost of the right-of-use asset), before any initial direct costs are considered.

On subsequent measurement of the right-of-use asset at fair value, valuation models for investment property will include ground lease payments as cash outflows and typically present the fair value on a net basis. However, IFRS 16 requires the lease liability and the right-of-use investment property to be presented on a gross basis on the balance sheet. To achieve this presentation, IAS 40 requires the amount of the recognised lease liability, calculated in accordance with IFRS 16, to be added back to the amount determined under the net valuation model, to arrive at the carrying amount of the investment property under the fair value model. Subsequent accounting considerations in relation to subleases entered into with tenants, where the underlying investment property is held under a lease, are discussed in [section 4.2](#).

Example – Accounting for investment property held under a lease

Reference to standard: [IFRS 16 para 22](#)

Reference to standing text: [23.36](#)

Industry: Real Estate

Background

On 1 January 20X1, entity A pays C1,000 in an arm's length transaction to obtain a leasehold investment property, consisting of a building and land subject to a ground lease. The ground lease has a lease term of 70 years.

Entity A is required to pay an annual ground rent of C50 during the lease period. Entity A is unable to readily determine the interest rate implicit in the lease and has calculated its incremental borrowing rate as 5%. Using this discount rate, it has determined that the present value of the future ground lease payments is C967.

Entity A applies the fair value model in accordance with IAS 40 to subsequently measure its investment properties. The amount of C1,000 paid by entity A represents the fair value of the leasehold investment property at the date of acquisition. Entity A did not incur any initial direct costs.

Solution

[Accounting at lease acquisition – 1 January 20X1](#)

IAS 40 requires the initial recognition of investment properties to be at cost. The amount of C1,000 is the consideration paid to acquire the leasehold investment property, including the assumption of the obligation to pay ground rent to the lessor under the lease. However, under IFRS 16, a lease liability as well as a right-of-use investment property must be recognised in respect of the ground lease. This results in the following entries on initial recognition:

Dr Investment property – C1,967

Cr Lease liability – C967

Cr Cash – C1,000

Accounting at 31 December 20X1

Entity A determines the fair value of the investment property (net of the future obligation to pay ground rent) to be C1,080 at this date. The valuation approach used to determine this amount includes the future cash outflows associated with the ground lease. Further, the valuation approach used assumes a market discount rate of 6%. As a result, the valuation amount can be analysed as follows:

Present value of future lease net operating income discounted at 6% – C1,898

Present value of future ground lease payments discounted at 6% – (C818)

Fair value of investment property – C1,080

Under IFRS 16, a lease liability in respect of the ground lease is reflected on the balance sheet. During the year, a ground lease payment of C50 was made, resulting in the following entries:

Dr Interest expense – C48

Dr Lease liability – C2

Cr Cash – C50

As a result, the carrying value of the lease liability as at 31 December 20X1 is C965 (being the initial carrying value of C967 less the principal payment of C2). In line with [paragraph 50\(d\) of IAS 40](#), since a separate liability is recorded on the balance sheet in respect of the ground lease, the carrying value of the investment property must reflect this. At 31 December 20X1, this would mean that the overall fair value of the investment property would be reflected on the balance sheet as follows:

Investment property – C2,045

Lease liability – (C965)

Net fair value – C1,080

In turn, the following entries would be recorded to recognise the revaluation of the investment property from C1,967 to C2,045:

Dr Investment property – C78

Cr Fair value gain – C78

The overall impact on the income statement is net income of C30 (being the fair value gain of C78 less the interest expense of C48).

From the perspective of the cash flow statement, payments relating to the ground lease are reflected as a financing cash outflow of C2 in respect of repayment of principal and an interest cash outflow of C48 (classified in accordance with the entity's policy for interest cash outflows).

2.3. Acquisition of investment properties: asset acquisition or business combination

Entities might acquire investment properties that meet the definition of an asset, or investment properties (together with other inputs and processes) that meet the definition of a business under IFRS 3.

It is also common in the real estate industry to structure property acquisitions and disposals in a tax-efficient manner. This often involves the transfer of a company, frequently referred to as a 'corporate wrapper', which holds one or more properties.

The accounting treatment for an acquisition depends on whether it is a business combination or an asset acquisition.

A 'business' is defined as an 'integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities'. [\[IFRS 3 App A\]](#).

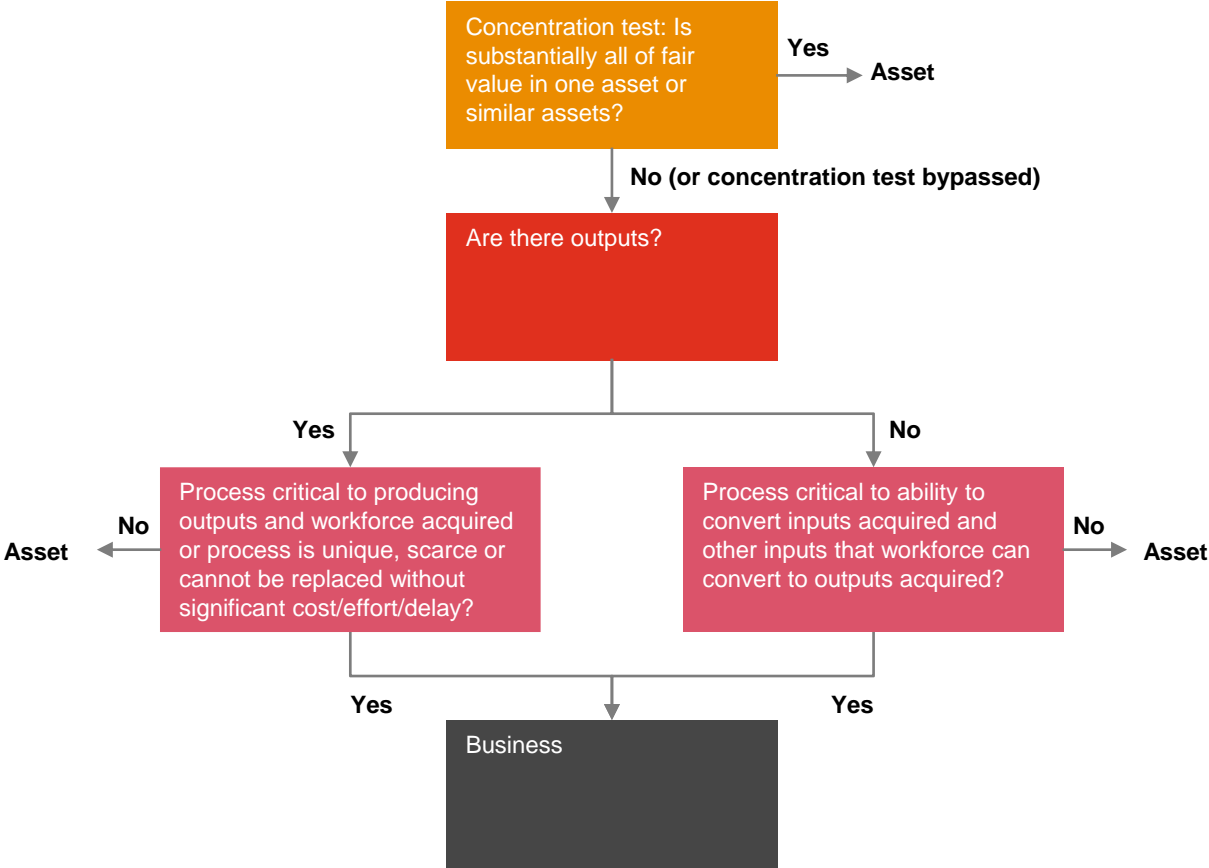
The legal form of the acquisition is not a determining factor when assessing whether a transaction is a business combination or an asset acquisition. For example, the acquisition of a single vacant investment property is not a business combination simply because it is purchased through a corporate wrapper. Similarly, a transaction is not an asset acquisition simply because the acquiring entity purchases a group of assets directly rather than purchasing shares of a company.

A transaction will qualify as a business combination only where the assets purchased constitute a business. Significant judgement is required in the determination of whether the definition of a business is met.

To be considered a business, an acquisition would have to include an input and a substantive process that together significantly contribute to the ability to create outputs. Not all of the elements need to be present for the group of assets to be considered a business:

- Outputs are not required for an integrated set to qualify as a business. [IFRS 3 App B para B7].
- A business does not need to include all of the inputs or processes that the seller used in operating that business. However, to be considered a business, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. [IFRS 3 App B para B8].

The guidance provides a framework to evaluate when an input and a substantive process are present, and it considers an optional concentration test that, if met, eliminates the need for further assessment.



The concentration test

Under the concentration test, companies consider whether substantially all of the fair value of the gross assets acquired is concentrated in a single asset (or a group of similar assets). If so, the assets acquired would not represent a business and no further analysis is required. Gross assets acquired exclude cash, deferred tax assets and any goodwill that results from the effects of deferred tax liabilities. The fair value of the gross assets acquired can usually be determined based on the consideration transferred (plus the fair value of any non-controlling interest and previously held interest, if any) plus the fair value of any liabilities assumed, other than deferred tax liabilities. In order to compare like with like, any items excluded from the 'gross assets acquired' would also be excluded from the 'fair value of gross assets acquired' calculation.

The optional concentration test includes the concept of aggregating 'similar' assets. In the real estate industry, it is common for acquisitions to include several properties. Entities should carefully consider the specific facts and circumstances, including class of property and location, when concluding whether assets purchased in a transaction are similar. A group of properties are not similar if they have significantly different risk characteristics. [IFRS 3 App B para B7B(f)(vi)].

Example – Acquisition of a residential real estate portfolio

Background

Property Co purchases a portfolio of 10 residential homes. Each home is considered to be a separate investment property for accounting purposes. All homes are leased out to separate tenants and comprise land and buildings. Each home has a different design and layout, but all homes are located in the same geographical area and the risk profile of the real estate market across that area is similar. No employees, other assets or other activities are transferred. Is the arrangement the acquisition of a business?

Solution

No. Property Co elects to apply the optional concentration test and would conclude that this is an asset acquisition, because substantially all of the fair value is concentrated in a group of similar assets. Property Co would treat this as an asset acquisition.

A transaction is not automatically a business combination if the optional concentration test does not result in an asset classification. An entity would then need to assess the transaction under the full framework.

Framework in IFRS 3

IFRS 3 requires a business to include, as a minimum, an input and a substantive process that together significantly contribute to the ability to create output. The guidance provides a framework to evaluate when an input and a substantive process are present, differentiating between transactions with outputs and those with no outputs. Outputs are defined as 'the results of inputs and processes applied to those inputs that provide goods or services to customers, generate investment income (such as dividends or interest) or generate other income from ordinary activities'. [IFRS 3 App B para B7].

Without outputs

An acquired process is considered substantive where the process is critical to the ability to convert an acquired input to an output. In addition:

- the inputs acquired include an organised workforce that has the necessary skills, knowledge and experience to perform that process; and
- other inputs are acquired that can be developed or converted into outputs by the organised workforce (for example, intellectual property, other economic resources that could be developed to create outputs, or rights to obtain materials that enable future output to be created).

With outputs

An acquired process is considered substantive where, either:

- the process is critical in continuing to produce outputs and the input includes an organised workforce with the necessary skills, knowledge or experience to perform that process; or
- the process significantly contributes to the ability to continue to produce outputs and is unique or scarce or cannot be replaced without significant cost.

Contracted workforce

An acquired contract could give access to an organised workforce (for example, outsourced property management services). The entity needs to assess whether the organised workforce provides a substantive process that it controls. Factors to consider include: the service is not ancillary or minor; it would be difficult to replace the workforce; and the duration of the contract and renewal terms.

Example 1 – Acquisition of a residential and office real estate portfolio

Background

Property Co purchases a portfolio of 10 residential homes (the nature of these homes being as outlined in the example above), as well as an office park containing five fully let office buildings. In addition, an outsourcing contract for maintenance services for the office park is also acquired. The maintenance services are considered ancillary or minor in the context of generating rental income at the office park. No employees, other assets or other activities are transferred. Is the arrangement the acquisition of a business?

Solution

No, Property Co would conclude that this is an asset acquisition.

The concentration test is not passed, since all of the fair value is not concentrated in a single identifiable asset or a group of similar identifiable assets. This is because two dissimilar classes of real estate with different risk profiles (that is, residential and office) are acquired.

Since there are leases in place for both the residential homes and office park buildings, Property Co would then analyse the transaction, referring to the framework with outputs and considering whether the acquired processes are substantive. No organised workforce is acquired and the maintenance services are considered ancillary or minor in the context of generating rental income. Further, the maintenance services do not significantly contribute to the ability to generate rental income and also could be replaced without significant cost.

Would the answer be different if there were no in-place lease contracts and, therefore, no outputs?

Analysis

No, Property Co would still conclude that this is an asset acquisition.

In order for the definition of a business to be met where there are no outputs, an organised workforce with the necessary skills critical to the ability to develop and convert the inputs into outputs would need to be present. Since no such organised workforce is acquired, the definition of a business is not met.

Example 2 – Acquisition of a residential and office real estate portfolio

Background

Property Co acquires a portfolio of residential and office assets (the nature of these assets being as outlined in the example above), and it also acquires employees that are responsible for operational management of the assets as well as all tenant management and leasing activity. Is the arrangement the acquisition of a business?

Solution

Yes. Property Co would conclude that this is a business combination.

The concentration test is not met, because the fair value of the assets acquired is not concentrated in a single asset or a group of similar identifiable assets. Further analysis is required, following the framework with outputs, to assess whether a process is acquired and whether the process is substantive. A business is acquired, because the organised workforce is a substantive process with the necessary skills that is critical to the ability to develop and convert the inputs (that is, the land, buildings and in-place leases) into outputs.

2.3.1. Accounting treatment for business combinations and asset acquisitions

The accounting treatment for an acquisition that is a business combination differs from the accounting when acquiring a group of assets that does not meet the definition of a business (that is, an asset acquisition).

The key considerations are explained below:

	Asset acquisition	Business combination
Standard	IFRS 3 – apply scope exemption explained in paragraph 2(b) and apply the relevant standards for the acquired assets/liabilities ¹	IFRS 3
Assets and liabilities	Allocate the purchase price to the individual identifiable assets and liabilities on the basis of their relative fair values	Recognise and measure the identifiable assets and liabilities at their acquisition date fair values
Deferred tax	No deferred tax is recognised under IAS 12, given the initial recognition exception [IAS 12 para 15(b)]	Deferred tax is recognised in accordance with IAS 12
Goodwill	Not recognised	Recognise any related goodwill or negative goodwill
Contingent liabilities	Not recognised, although the presence of contingent liabilities might impact transaction price and asset valuation	Contingent liabilities that are a present obligation arising from past events and can be reliably measured should be recognized at fair value. This is the case even if it is not probable that a future outflow of economic benefits will occur
Transaction costs	Form part of the cost of the asset	Expensed in the period incurred
Subsequent measurement implications	Follow relevant standards for each asset	Follow relevant standards for each asset For contingent liabilities, these should be measured at the higher of: <ul style="list-style-type: none"> the amount that would be recognised under IAS 37; and the amount initially recognised, less (if appropriate) the cumulative income recognised Annual impairment test for any recognised goodwill is required (see section 3.4.5)

2.3.2. Accounting for deferred tax at initial recognition

One of the more important features for the real estate industry, in respect of the accounting for deferred tax, is the initial recognition exemption in [paragraph 15\(b\) of IAS 12](#), which applies for property acquisitions outside a business combination.

Deferred tax is recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from the initial recognition of goodwill or the initial recognition of an asset or liability in a transaction that is not a business combination and that, at the time of the transaction, affects neither accounting profit nor taxable profit [[IAS 12 para 15](#)], often referred to as the initial recognition exemption. Further guidance on the recognition of deferred tax can be found in the [PwC Manual of Accounting chapter 14 paragraph 18](#).

¹ [Paragraph 2\(b\) of IFRS 3](#) removes from the scope of the standard the acquisition of an asset or a group of assets that does not meet the definition of a business. In such cases, the acquirer recognises the acquired assets and assumed liabilities in accordance with the relevant standards. The cost should be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the purchase date.

For periods beginning on or after 1 January 2023, IAS 12 was amended to include an additional condition where the initial recognition exemption is not applied. Under the amendment, a temporary difference that arises on initial recognition of an asset or liability is not subject to the initial recognition exemption if that transaction gave rise to equal amounts of taxable and deductible temporary differences. An example of this would be the acquisition of investment property held by way of a lease if initial recognition of the lease liability and corresponding right-of-use asset gives rise to equal amounts of taxable and deductible temporary differences. The recognition guidance in IAS 12 for deferred tax assets and deferred tax liabilities is applied to these deductible and taxable temporary differences, respectively.

It is important therefore to determine whether or not the transaction is a business combination or an asset acquisition (see section 2.3).

	Asset acquisition	Business combination
Background	An investment property with a fair value of C100 is acquired in a 'corporate wrapper' (see section 2.3). The purchase price amounts to C90. The discount is the result of the seller and the buyer negotiating the price, based on the fact that the property's tax base in the 'wrapper' is C50. For simplicity, it is assumed that there are no transaction costs and that the blended tax rate is 40%	
Solution	In the group accounts, the investment property is recognised at its cost of C90. At the point of acquisition, there is a temporary difference of C40 (being the carrying value of C90 less the tax base of C50). No deferred tax liability is recognised, because this is prohibited by the initial recognition exemption in paragraph 15(b) of IAS 12.	In the group accounts, the investment property is recognised at its fair value of C100. At the point of acquisition, there is a temporary difference of C50 (being the carrying value of C100 less the tax base of C50). This results in a deferred tax liability of C20 (C50 × 40%) that must be recognised as part of the business combination accounting.

The following entries are recorded at acquisition:

	Dr (C)	Cr (C)	Dr (C)	Cr (C)
Investment property	90		100	
Goodwill			10	
Cash		90		90
Deferred tax liability				20

Subsequent to initial recognition, the investment property must be recorded at its fair value of C100, resulting in the following entries in the case of an asset acquisition (assuming no change in the tax base):

	Dr (C)	Cr (C)	Dr (C)	Cr (C)
Investment property	10	-	-	-
Deferred tax liability	-	4	-	-
Gains or losses from fair value change	-	10	-	-
Deferred tax expense (CU10 × 40%)	4	-	-	-

Goodwill that arises on the acquisition of an investment property that is a business might result (partially) from the recognition of deferred tax. Such goodwill must be tested for impairment annually (see [section 3.4.5](#)).

2.3.3. Accounting for portfolio premiums/discounts

Entities acquire real estate properties either individually or in a portfolio. The price paid to acquire a portfolio of properties in a single transaction could differ from the sum of the fair values of the individual properties.

Portfolio premiums (discounts) are the excess (shortfall) of the market value of a portfolio of properties compared to the aggregate market value of the properties taken individually. Such premiums (discounts) affect the allocation of consideration.

Portfolio premiums could arise as a result of a purchaser’s ability to build a portfolio immediately rather than over a period of time, short supply in the market, or because of saved transaction costs. In some instances, expected portfolio synergies might also result in portfolio premiums. In such a case, it is important to consider whether the existence of a portfolio premium is an indicator of a business combination as opposed to the acquisition of a group of assets.

Portfolio discounts could be granted by a seller in order to encourage a single buyer to purchase a large number of properties, and thereby avoid future marketing and other administrative costs associated with selling properties one-by-one.

The accounting for such portfolio premiums (discounts) at initial recognition differs, depending on whether the transaction qualifies as a business combination or not.

The following table summarises the principles of accounting for portfolio premiums and discounts paid when acquiring a portfolio of real estate properties:

Portfolio premiums	Asset acquisition	Business combination
Initial measurement	The consideration is allocated to the underlying assets proportionately to their fair value. Premiums (discounts) might result in a higher (lower) amount being allocated to the investment property when compared to its fair value.	The assets and liabilities acquired are recognised at fair value, so any premiums or discounts affect the amount of goodwill arising from acquisition accounting. If the discount results in negative goodwill (bargain purchase), the gain is recognised in profit or loss.

2.4. Asset acquisitions: measurement at initial recognition

The rules for recognition of real estate that meets the definition of investment property are similar to those for all other assets. Investment properties (that are not a business) are initially recognised at cost, including transaction costs. [\[IAS 40 para 20\]](#).

Cost is generally the amount of cash or cash equivalents paid, or the fair value of other consideration given, to acquire an asset at the time of its acquisition or construction. [\[IAS 40 para 5\]](#).

An entity might acquire investment property for an initial payment, plus agreed additional payments contingent on future events, outcomes or the ultimate sale of the acquired asset at a threshold price. The entity will usually be contractually or statutorily obligated to make the additional payment if the future event or condition occurs. This is often described as variable or contingent consideration for an asset.

These types of arrangements need to be analysed carefully to determine whether or not the future variable or contingent payment is related to the cost of the asset. Payments which are not related to the cost of the asset should be expensed as incurred. The accounting for contingent consideration of an asset has been discussed by the IFRS Interpretations Committee although it has currently not provided further guidance in the form of an interpretation or an agenda decision that explains how the existing guidance is applied. An entity should therefore develop an accounting policy for contingent consideration related to the cost of acquiring an investment property that is consistently applied in accordance with IAS 8. There is diversity in practice in accounting for contingent consideration of an asset, with three acceptable approaches.

1. Financial liability model

Investment property is initially recognised including the fair value of the future contingent payments, and a financial liability is recognised at the same fair value of contingent payments. Subsequently, the financial liability is measured at amortised cost, following the requirements of IFRS 9. The entity should adjust the

carrying amount of the financial liability to reflect actual and updated estimated cash flows whenever the cash flow estimates are revised. The entity recalculates the carrying amount of the liability by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, where applicable, the revised effective interest rate calculated in accordance with IFRS 9 paragraph B5.4.6. Subsequent changes in the measurement of the liability are unrelated to the cost of the asset. Those adjustments are therefore recognised in profit or loss as income or expense.

2. Cost accumulation model

Investment properties are initially recognised, at the date of acquisition, at the amount of consideration paid. Variable payments contingent on future events are not included in the carrying amount of the asset on day 1, and no liability is recognised for these payments. The entity does not recognise a liability because, following the agenda decision by the IFRS Interpretations Committee to not include the accounting for contingent consideration to acquire an asset to its agenda because it is too broad, it is not clear that there is an obligation before the uncertainty is resolved. The IFRS Interpretations Committee also noted, in the 2016 agenda decision, that there are unanswered questions about the accounting for subsequent payments. An entity could therefore choose to capitalise the variable payments as part of the cost of the asset when paid, on the basis that these payments represent the direct cost of acquisition. This treatment is typically only acceptable if a change in the variable payment is as a consequence of the utility of the asset. If the variation is as a consequence of another factor not associated with the asset, the accounting for that aspect of the variable payment would generally follow the applicable guidance in IFRS.

3. Analogy to IFRIC 1 approach

Investment properties are initially recognised at cost, at the date of acquisition, which includes an estimate for the future anticipated variable costs. A liability will be recognised at the same time. The liability is subsequently measured at amortised cost, in a similar way to approach 1 above. However, subsequent changes in the liability will be recognised against the cost of the asset. This treatment is typically only acceptable if a change in the variable payment is as a consequence of the utility of the asset. If the variation is as a consequence of another factor not associated with the asset, the change in cost would generally follow the applicable IFRS guidance.

2.4.1. Accounting for transaction costs, start-up costs and subsequent costs shortly after acquisition

Cost is the purchase price, including directly attributable expenditures. Such expenditures include transaction costs (such as legal fees and property transfer taxes) and, for qualifying properties under construction not subsequently measured under the fair value model, borrowing costs in accordance with IAS 23.

Except for transaction costs relating to acquisitions that meet the definition of a business combination, external transaction costs are included in the cost of acquisition of the investment property.

The cost of acquired investment property excludes internal transaction costs (for example, the cost of an entity's in-house lawyer who spends a substantial amount of time drafting the purchase agreement and negotiating legal terms with the seller's lawyers). The entity cannot apportion the in-house lawyer's salary and include an estimated amount related to the work on the acquisition of a property in the cost of that property. The in-house lawyer's employment-related costs are internal costs that relate to 'general and administrative costs', and they are not directly attributable to the acquisition of the property.

Example – Market study research costs (1)

Background

Entity Y purchased an investment property in Lisbon. It performed a study of the real estate market in Portugal before it purchased the property. Management proposes to capitalise the costs of this study.

Can management capitalise the real estate study costs?

Solution

No. The costs cannot be capitalised, since the costs of the market study are not directly related to the acquired property. Such costs are pre-acquisition costs, and they are expensed as incurred.

Example – Market study research costs (2)

Background

Entity A has a 31 December year end, and it adopts the fair value model for its investment properties (see [section 3.5](#)).

Entity A acquired a property in December 20X1 at a cost of C100, and it incurred transaction costs amounting to C5. There is no movement in the underlying market value of the property between the acquisition date and the year-end date, so the fair value of the investment property at 31 December 20X1 is C100.

How should the entity account for the transaction costs incurred?

Solution

Investment property is initially measured at the cost of C105, including the transaction costs of C5. [\[IAS 40 para 20\]](#). Transaction costs include legal fees, property transfer taxes etc that are directly attributable to the acquisition of the property. [\[IAS 40 para 21\]](#). However, investment property measured subsequently at fair value cannot be stated at an amount that exceeds its fair value. At 31 December 20X1, entity A should report its investment property at the fair value of C100, and it should recognise a loss of C5 in its income statement.

The cost of an investment property excludes items such as:

- start-up costs, unless they are necessary to bring the property to its working condition;
- initial operating losses incurred before the investment property achieves the planned level of occupancy; and
- abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

Such costs, incurred in the period after the acquisition or completion of an investment property, do not form part of the investment property's carrying amount, and they should be expensed as incurred. [\[IAS 40 paras 21–23\]](#).

An entity might incur costs subsequent to completion of a property but before it can be put to its intended use (for example, where a regulatory approval must be obtained first). Costs incurred subsequent to the completion of the property are either:

- expensed, where they relate to maintenance of the building and attracting new tenants; or
- capitalised, where they enhance the value of the asset or where they help to bring the asset to an operational condition.

Example – Costs incurred subsequent to completion: prior to being fully let

Background

Entity M develops an office building for rental. Subsequent to completion of the building, it incurs expenses (such as security, utilities and marketing) before the building has secured a reasonable level of occupancy. The time between the building's completion and securing a reasonable number of tenants is three months. Management considers capitalising these operating costs that are incurred in this period.

Can entity M capitalise costs that are incurred after the date of completion of the property and prior to it being fully let?

Solution

No. The costs should be expensed as incurred. These costs relate to maintaining the building and attracting tenants. They are not necessary in bringing the asset to an operational condition.

Example – Costs incurred subsequent to completion and prior to approval by relevant government agency

Background

Entity N develops an office building for rental, and it incurs expenses (such as security and utilities) subsequent to completion. The building was physically completed on 31 March, but the local health and safety regulator did not clear the property for use until 30 June, when the security system met the required conditions. The delay of three months in receiving health and safety approval is standard for the type and location of the building. Entity N incurred C100,000 security expenses in the period between 31 March and 30 June. These costs were necessary in order to ensure that the required conditions for health and safety approval could be satisfied.

Can entity N capitalise those costs in the period between the date of completion and the date when the building receives approval for use from the relevant government agency?

Solution

Yes. The security expenses incurred during the period from 31 March to 30 June should be capitalised. The legal requirement to receive the regulatory clearance meant that the building could not be put to its intended use, although construction was completed on 31 March.

2.4.2. Accounting for forward contracts and options to acquire real estate

Entities might enter into forward contracts or options for purchasing investment property. Contracts to buy a non-financial asset (such as property) that are entered into for the purposes of receipt of that non-financial asset, and that cannot be settled net in cash or another financial instrument, are outside the scope of IFRS 9. [IAS 32 para 8]. Since the contract will be settled by physical delivery of property (typically land) rather than by delivery of a financial asset or exchange of financial instruments and cannot be settled net in cash, it is not accounted for as a derivative.

Entities usually make a small initial deposit payment to enter into these contracts. This initial deposit payment is recognised in the balance sheet if it meets the definition of an asset. The cost can be measured reliably, since it is the amount paid. If it is probable that the acquisition of the property will occur in the future, or economic benefits could be derived from this option in some other way (for example, if it is possible to sell the option to a third party), the recognition criteria for an asset are met.

The contract does not meet the definition of investment property, since it has not yet represented a current interest in property. In substance, it is the first payment to secure the future acquisition of the property. If the property is subsequently acquired, the amount paid for the option (or forward) would form part of the cost of that property.

The amount paid to the owner of the property for the option or forward is recognised as a non-financial asset. If future economic benefits are no longer expected to occur, for example, if acquisition of the property is no longer probable, and economic benefits cannot be derived from the option in any other way, such as the absence of the ability to sell the option to another party or obtain a refund, the asset is derecognised. The asset would also need to be assessed for indicators of impairment in accordance with IAS 36.

Where the asset is denominated in a foreign currency, an entity will need to determine whether the asset is monetary or non-monetary in the context of IAS 21. For example, if the asset is non-refundable, it will be treated as a non-monetary item; whereas, if the amount is fully refundable, it will be treated as a monetary item. Judgement might be required in determining whether or not the asset is a monetary or non-monetary item, considering the terms of the specific contract. On initial recognition, the asset should be translated to the entity's functional currency using the spot rate at the date of the transaction. For a non-monetary asset, the date of the transaction, should be the date on which an entity initially recognises the non-monetary asset arising from the advance deposit or prepayment. [IFRIC 22 para 8]. If there are multiple payments or receipts in advance of recognising the related item, the entity should determine the date of the transaction for each payment or receipt. [IFRIC 22 para 9]. Non-monetary items are not remeasured to reflect changes in foreign currency. If the asset is a monetary item, it will need to be remeasured at each reporting date, using the closing rate. If it is a non-monetary item, no remeasurement should be performed.

Example – Land options

Background

Entity A made a one-off payment to entity B for the option to buy entity B's land within the next 10 years, subject to planning permission for development being achieved. The price of the land will be based on market value at the time of exercise, less the initial one-off payment already made. The initial one-off payment for the option is non-refundable. Entity A plans to develop the land into investment property when it is acquired. Entity A has a high expectation of purchasing the underlying land.

How should the initial payment for the land option be accounted for?

Solution

Provided that it is probable that entity A can derive future economic benefits from the land option, the one-off payment is recognised as a non-financial asset in the statement of financial position. The subsequent measurement is at cost and will be assessed for impairment under IAS 36.

Example – Purchase of an investment property: share deal

Background

Entity A enters into a forward contract to purchase 100% of the outstanding shares of entity X in six months' time. Entity X holds a single property that is currently rented out to a single lessee on a long-term lease contract.

The final purchase price is calculated as the pro rata share of the equity presented in the balance sheet of entity X at the settlement date. The investment property held is accounted for under the fair value model in entity X's financial statements. The contract does not contain any net settlement provisions.

Entity A will be required to consolidate entity X when control is transferred (see section 5.1). Entity A intends to use the property as investment property.

Should entity A account for the forward purchase contract as a derivative within the scope of IFRS 9?

Solution

There are two permissible accounting approaches in this case. Entity A should select an accounting policy approach and apply that approach consistently.

Accounting policy 1 – Forward purchase contract is accounted for as the purchase of an investment property, based on the economic substance of the contract

The forward purchase contract has the economic substance of a contract to purchase investment property, and it is outside the scope of IFRS 9 as a result of the own use exemption. [IFRS 9 para 2.4]. The economic substance needs to be considered; this is because the legal form of the purchase contract, being a contract to purchase shares rather than an asset, should not impact the accounting.

Accounting policy 2 – Forward purchase contract is accounted for as a derivative, based on the legal structure of the contract

Entity A intends to purchase the outstanding shares of an entity. Therefore, the forward purchase contract is within the scope of IFRS 9. Entity A has the right to receive 100% of the shares of entity X, and it has the obligation to pay the purchase price at the settlement date. Accordingly, the forward purchase contract is within the scope of IFRS 9.

Note that, if entity A had entered into a contract to purchase 50% of the outstanding shares of entity X resulting in entity X being a joint venture, the above accounting policy choice would not apply. Where entity A has entered into a joint venture arrangement, the substance of the transaction would be broader than just purchase of an investment property. As a result, such a contract would be accounted for as a derivative within the scope of IFRS 9. [IFRS 9 para 2.1(a)].

Example – Purchase of an investment property: asset deal

Background

Entity A enters into a contract to purchase a property in six months' time. Entity A is required to pay the fixed purchase price for the property, and the counterparty is required to transfer all rights attached to the property at the future settlement date. The contract does not contain any net settlement provision. Entity A pays a small signing fee to the seller in order to enter into the purchase contract. The non-refundable deposit is deductible from the final amount that entity A pays at the settlement date, and it is considered by the entity as a down payment.

Entity A intends to use the property, which is rented out to a single lessee on a long-term lease contract, as an investment property in accordance with IAS 40.

Should entity A account for the forward purchase contract to buy an investment property as a derivative within the scope of IFRS 9?

Solution

Entity A enters into a contract to purchase a non-financial instrument which cannot be settled net in cash and which has been entered into and is held for the purpose of delivery of the investment property for its own use. Thus, the forward purchase contract is not within the scope of IFRS 9. The non-refundable deposit should be recognised as a prepayment on the balance sheet.

2.5. Special considerations: investment properties under construction

An entity might enter into a binding forward purchase agreement to purchase a completed property after construction is completed. Where the contract requires the entity to pay a fixed purchase price, the entity will need to consider whether the contract is onerous. A provision for onerous contracts is recognised if the unavoidable costs of meeting the obligations under the contract or exiting from it exceed the economic benefits expected to be received under it. [IAS 37 paras 66–69].

For example, if this fixed price has a net present value of CU100 million at the reporting date, and the estimated economic benefits of the completed investment property at the reporting date is below that (say, CU80 million), a loss of CU20 million is recognised immediately in the income statement. The resulting provision is recognised on the balance sheet, unless there is an asset dedicated to the contract.

If there is an onerous contract as defined above, an impairment test is performed on any asset dedicated to the contract (for example, prepayments made in relation to the purchase). Such an asset relating to an onerous contract is written down to the recoverable amount (see [section 3.4](#) for further guidance on impairment), if this is less than the carrying amount. [IAS 37 para 69]. A provision is recognised only after such an asset is reduced to zero.

Regardless of the assessment as to whether or not there is an onerous contract, contractual obligations to purchase, construct or develop investment property, or for repairs, maintenance or enhancements, should be disclosed.

[IAS 40 para 75(h)].

2.6. Accounting for rental guarantees

Sellers of real estate might provide guarantees to the potential buyers. A typical rental guarantee contract usually has the following characteristics:

- The seller guarantees a minimum tenancy level of the building.
- The buyer does not need to meet certain requirements to be eligible to receive payment.
- The payments under the guarantee do not change based on market yields, but rather they represent a percentage of the initial purchase price of the building.

From the buyers' perspective, contracts with the above characteristics are contingent consideration for the asset classified as financial assets measured at fair value through profit or loss in accordance with IFRS 9. This is because a rental guarantee contract with the features above will not comprise solely payments of principal and interest. The fair value of the contract is separated from the purchase price on initial recognition of the property. Subsequently, the rental guarantee asset is measured at fair value at each reporting date, with changes either recognised in profit or loss or added to the property cost. Both approaches for the subsequent measurement are acceptable. This is a policy choice that should be applied consistently to all similar transactions and appropriately disclosed. See [section 2.4](#) for more information on asset acquisition with variable or contingent consideration.

From the sellers' perspective, there is diversity in practice in accounting for rental guarantees, with two approaches observed.

The first approach is that contracts with the above characteristics might be viewed as a financial liability assumed in the transaction and classified in accordance with IFRS 9 as an 'other financial liability' (or a derivative, if appropriate). This approach might be appropriate where the rental guarantee is dependent on market factors, such as the fair value of the asset. The liability is initially recognised at its fair value for the consideration to be paid under the rental guarantee, reducing revenue for the sale of the real estate. Changes to the expected cash flows are subject to the provisions of paragraph B5.4.6 of IFRS 9 as follows:

- The entity should revise its estimates of receipts by adjusting the carrying amount of the financial liability.
- The difference between the carrying value and the revised amount, using the revised cash flows discounted at the original effective rate, is recognised in profit or loss.

The second approach is that the rental guarantee could be accounted for as variable consideration within the scope of IFRS 15. If the rental guarantee is related to the performance and quality of the property being sold and is contingent on the occurrence or non-occurrence of a future event, sellers apply the variable consideration guidance in IFRS 15 (see section 4.13.2). In this case:

- The estimated rental guarantee payment (as determined following the variable consideration guidance in IFRS 15) will reduce the transaction price.
- A refund liability for this amount will be recognised, reducing the revenue or net gain on sale as appropriate.
- Any subsequent changes in the rental guarantee liability will be adjusted against revenue or the net gain on sale as appropriate.

There is judgement involved in determining which approach is appropriate for each specific fact pattern and whether the variability arises from market factors, the performance/quality of the property, or a mixture of the two. Factors to consider include whether the rental guarantee payment is dependent on:

- future fair value of the building and property in the market (that is, market factors) – this might suggest a financial liability approach;
- current and/or future tenancy level of the building – this might suggest a variable consideration approach; or
- current and/or future total rent receivable amount of the building – this might suggest a variable consideration approach.

This judgement should be applied consistently to all similar transactions and appropriately disclosed.

Example – Rental guarantees: buyer's perspective
<p>Background</p> <p>On 1 January 20X1, entity A acquired an investment property from entity B, a property developer, for C100. Entity B provided a rental guarantee to entity A as follows:</p> <ul style="list-style-type: none">• Entity B guarantees to entity A that, if the property is not fully rented during the first three years post acquisition, entity B will compensate entity A.• The maximum amount of compensation payable to entity A is 5% of the total purchase price paid by entity A; if entity A is unable to rent the building to any tenants and the building remains vacant for each of the first three years, entity B will pay C5 (being 5% of the purchase price) to entity A.• Compensation for part occupancy of the building is calculated as the proportionate amount of the maximum guarantee; for example, for 20% vacancy, the guarantee amount to be paid would be C1 (that is, 20% of C5). <p>At the acquisition date, the property is partially rented out (80%). Entity A expects the vacancy rates to be constant over the next three years. Accordingly, entity A expects to receive C3 over the next three years (C1 per year).</p> <p>The fair value of the rental guarantee has been determined to be C3 (for simplicity, the time value of money has been ignored).</p> <p>The fair value of the property, without the guarantee, at the acquisition date is C97. On 31 December 20X1, the fair value of the property without the guarantee is C95. There are no transaction costs, no VAT and no transfer tax. Entity A has an accounting policy to measure investment property at fair value.</p> <p>On 31 December 20X1, entity A received payment of C1 compensation for the first year. Due to a change in market conditions, the estimated vacancy rate for the second year increased to 40%. Entity A expects that this</p>

will also be the case for the third year. The new cash flow projection estimates a payment of C2 per year for the next two years, resulting in a fair value of the rental guarantee at 31 December 20X1 of C4.

How should entity A account for the rental guarantee provided by entity B?

Solution

Entity A recognises the property and a rental guarantee financial asset on initial recognition. The financial guarantee is recognised at fair value on initial recognition (C3), and the remaining amount is allocated to the investment property.

On initial recognition, the following is recorded:

	Dr (C)	Cr (C)
Investment property (allocated cost)	97	-
Rental guarantee (financial asset at fair value through profit or loss)	3	-
Cash	-	100

As at 31 December 20X1, the investment property is measured at fair value, and fair value changes are recognised in profit or loss.

	Dr (C)	Cr (C)
Profit or loss	2	-
Investment property	-	2

Entity A receives a payment of C1 from entity B, since the vacancy rate for the first year was 20%.

	Dr (C)	Cr (C)
Cash	1	-
Rental guarantee (financial asset at fair value through profit or loss)	-	1

The fair value of the rental guarantee would be C4 (ignoring discounting). Entity A could select an accounting policy to record the subsequent changes from rental guarantee through profit or loss.

	Dr (C)	Cr (C)
Rental guarantee (financial asset at fair value through profit or loss)	2	-
Profit or loss	-	2

Alternatively, entity A could select an accounting policy to record the subsequent changes from rental guarantee as part of the property cost. In this case, since the investment property is measured at fair value, the corresponding changes will be reflected as fair value changes in investment properties in profit or loss. This accounting policy choice would be applied consistently to all property asset acquisitions.

Example – Rental guarantees: seller's perspective

Background

The facts are as in the above example.

Entity B is a property developer, so the property is classified as inventory, because the property has been constructed with the view to sell. The cost of construction is C95 and it is assumed that costs to sell are nil.

How should entity B account for the rental guarantee provided to entity A?

Solution

Approach one: accounting under IFRS 9

Entity B has assessed the fact pattern to determine whether the variability arises from market factors, the performance/quality of the property, or a mixture of the two, to determine which standard to apply. Entity B concludes that IFRS 9 is appropriate in this instance, and it accounts for the rental guarantee as an other financial liability.

Entity B derecognises the property and recognises a rental guarantee financial liability at fair value of C3 on initial recognition.

On initial recognition, the following is recorded:

	Dr (C)	Cr (C)
Cash	100	-
Revenue	-	97
Rental guarantee (financial liability)	-	3
Cost of sales	90	-
Inventory	-	90

As at 31 December 20X1, entity B makes a payment of C1 to entity A, since the vacancy rate for the first year was 20%.

	Dr (C)	Cr (C)
Rental guarantee (financial liability)	1	-
Cash	-	1

As at 31 December 20X1, entity B revises the rental guarantee financial liability using the revised cash flows (C4) discounted at the original effective interest rate. Assume that the revised carrying value is C4 (ignoring the effect of discounting).

	Dr (C)	Cr (C)
Profit or loss	2	-
Rental guarantee (financial liability)	-	2

Approach two: accounting under IFRS 15

Entity B has assessed the fact pattern to determine whether the variability arises from market factors, the performance/quality of the property, or a mixture of the two, to determine which standard to apply. Entity B concludes that IFRS 15 is appropriate in this instance.

Entity B derecognises the property and recognises a refund liability, following the variable consideration guidance in IFRS 15. The revenue from the sale of the property must be constrained to ensure that it is highly probable that a significant reversal in the amount of cumulative gain recognised will not occur when the uncertainty associated with the rental guarantee is resolved. Assuming that the rental guarantee payment is initially measured at C6 based on the variable consideration guidance, on initial recognition, the following is recorded:

	Dr (C)	Cr (C)
Cash	100	-
Revenue	-	94
Refund liability (rental guarantee)	-	6
Cost of sales	90	-

Inventory	-	90
As at 31 December 20X1, entity B makes a payment of C1 to entity A, since the vacancy rate for the first year was 20%.		
	Dr (C)	Cr (C)
Refund liability (rental guarantee)	1	-
Cash	-	1
As at 30 December 20X1, entity B revises its estimated rental guarantee payment based on variable consideration guidance under IFRS 15. Assume that the revised carrying value is C4.5 (ignoring the effect of discounting). This is adjusted through the same income statement line item as at contract inception.		
	Dr (C)	Cr (C)
Revenue		0.5
Refund liability (rental guarantee)	0.5	

See section 4.13.2 for further guidance on accounting for variable consideration, and section 6.2.1 for guidance on deferred sales proceeds with significant financing components.

2.7. Development properties: accounting for the costs of construction

2.7.1. Capitalisation of construction costs

Investment property under construction is initially measured at cost. Cost is usually the price paid to the developer to construct the property, together with any directly attributable costs of bringing the asset to the condition necessary for it to be capable of operating in the manner intended by management.

Costs that are eligible for capitalisation include, but are not limited to:

- contract costs with the developer;
- architect fees;
- civil engineer fees; and
- staff costs for employees employed specifically for the construction process.

Costs that are not eligible for capitalisation include, but are not limited to:

- abnormal amounts of wasted materials and labour or other resources, such as for errors (including design errors);
- storage and leasing costs of equipment located at construction sites that continue to be incurred during a pause in construction (other than pauses that are directly attributable to bringing the asset to the condition necessary for it to be capable of operating in the manner intended by management);
- feasibility studies in identifying development opportunities; and
- staff costs for project management if these would be incurred irrespective of any development.

2.7.2. Demolition costs

An entity might acquire a property and demolish some of the existing buildings in order to construct new buildings. Demolition costs are capitalised as part of the investment property if they are directly attributable to bringing the asset to the location and condition for its intended use. [IAS 16 paras 16(b), 17(b)]. Depending on the condition of the acquired property, these costs might be recognised as part of the cost of the land or the cost of the building. Correct classification will impact future depreciation where the cost model is applied and the land and buildings are subject to different depreciation rates.

Example – Demolition of a building (1)

Background

Entity A acquires a property for C100.

The fair value of the property (land and a building) is represented by the value of the land only, because the current building on the land is derelict and unusable.

The building is demolished after purchase, in order to construct a new building in its place. Entity A incurs demolition costs of C3.

How should entity A account for the acquisition cost of the property and the costs of demolition?

Solution

Entity A should recognise C100 as the cost of the land, and it should not allocate any part of the purchase price to the building. The purchased building is derelict and does not have stand-alone value, since no market participant would be willing to pay consideration for an unusable building. [IAS 16 para 7]. The economic rationale behind the purchase was to acquire land, rather than land and a building. The sole purpose of the demolition was to bring the land to its intended use because it would not be available for use until the building was demolished. Therefore, all consideration paid (C100 million) should be allocated to the land.

The demolition costs of C3 are capitalised as part of the cost of the land. In accordance with paragraphs 16(b) and 17(b) of IAS 16, this represents costs directly attributable to bringing the land to the condition necessary for it to be capable of being developed. Without demolishing the existing building, the intended use of the land cannot be realised.

Cost of	Land (C)	Building (C)
Initial acquisition costs	100	-
Demolition	3	-
Cost – post demolition	103	-

Example – Demolition of a building (2)

Background

Entity B purchases land together with a building. The purchase price is C200. The fair value of the property is C190 for the land and C10 for the building. The building has value because a market participant would normally use the building rather than demolish it.

Entity B plans to demolish the building immediately after purchase, in order to construct a new building in its place. The costs of demolishing the old building will be C3.

How should entity B account for the acquisition cost of the property and the demolition costs?

Solution

Entity B should recognise C190 as the cost of the land and C10 as the cost of the purchased building. This is because the purchased building has value, based on the fact that a market participant would normally use the building rather than demolish it. The intended use of the land has already been achieved – in contrast to the previous example, where the intended use had not been achieved, because of the presence of the derelict building on the land. On demolition, the carrying value of the building is derecognised and expensed to the income statement.

The demolition costs of C3 are capitalised as part of the cost of the new building. In line with paragraphs 16(b) and 17(b) of IAS 16, this represents costs directly attributable to constructing the new building, and they are capitalised when incurred.

Cost of	Land (C)	Building (C)
Initial acquisition costs	190	10
Demolition of old building (Profit or loss)		(10)
Demolition costs – part of new building		3
Cost – post demolition	190	3

2.7.3. Borrowing costs for properties under construction

The cost of investment property might include borrowing costs incurred during the period of construction.

Under IAS 23, borrowing costs are capitalised if an asset takes a substantial period of time to get ready for its intended use. Capitalisation of borrowing costs is optional for qualifying assets that are measured at fair value (for example, investment property under IAS 40). [IAS 23 para 4(a)].

Borrowing costs include, but are not limited to:

- interest expense calculated using the effective interest method, as described in IFRS 9;
- finance charges in respect of leases in accordance with IFRS 16; and
- exchange differences arising from foreign currency borrowings, to the extent that they are regarded as an adjustment to interest costs.

Borrowing costs should be capitalised while construction is actively underway.

These costs include the costs of:

- specific funds borrowed for the purpose of financing the construction of the asset; and
- general borrowings, being all borrowings that are not specific borrowings for the purpose of obtaining a qualifying asset. The general borrowing costs attributable to an asset's construction should be calculated by reference to the entity's weighted average cost of general borrowings.

Capitalisation starts when all three of the following conditions are met:

- expenditures for the asset are incurred;
- borrowing costs are incurred, and
- the activities necessary to prepare the asset for its intended use are in progress.

Capitalisation of borrowing costs in respect of real estate developments can commence before the physical construction of the property (for example, when obtaining permits, completing architectural drawings, or performing other activities necessary to prepare the property for its intended use).

Example – Capitalisation of borrowing costs

Background

Entity A contracts a third party for the construction of a building. Entity A will make progress payments to the third party over the construction period of the building.

Entity A obtains a loan from the bank to finance the progress payments made to the third party, and it incurs borrowing costs on this loan.

How should entity A account for the borrowing costs incurred?

Solution

The borrowing costs incurred by entity A, to finance prepayments made to a third party to construct the property, are capitalised on the same basis as the borrowing costs incurred on an asset that is constructed by the entity itself.

Capitalisation should start when:

- expenditures are incurred – that is, when the prepayments are made;
- borrowing costs are incurred – that is, when borrowing is obtained; and
- the activities necessary to prepare the asset for its intended use are in progress – that is, when a third party has started the construction process; determining whether construction is in progress will likely require information directly from the contractor.

An entity should suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset. Where construction activities are interrupted, but the cessation is a necessary and foreseeable part of the process, capitalisation of borrowing costs can continue. In addition, if substantial technical and administrative work continues during a suspension in physical construction, borrowing costs would likely continue to be capitalised.

For other suspensions such as revised business plans or certain unanticipated government-imposed restrictions, the assessment of whether or not the suspension results in an extended period in which active development on a qualifying asset has ceased is a matter of judgement. IAS 23 does not provide guidance regarding what it envisages to be an 'extended period'. Management may consider, among other things, the expected total period of suspension, including the possibility of the suspension being extended, and the projected length of the delay relative to the time period ordinarily expected for the construction of the specific asset. The shorter the projected length of delay relative to the project as a whole, the more likely it is that borrowing costs should continue to be capitalised.

2.7.4. Income arising on redevelopment of property

Properties might need to be redeveloped following initial acquisition. Redevelopment might include structural changes to the building, renovations or construction of new facilities. Property owners usually contract property developers to run the redevelopment process.

Depending on the extent of redevelopment, property owners might be unable to lease out the property to tenants and generate income during the redevelopment period. Developers might undertake to compensate the property owners for their loss of income during the period by agreeing to refund the owners for a 'licence' or 'interest' fee. The fee is normally paid throughout the period of redevelopment, and its payment usually reduces the total development cost payable to the developer. Such payment is neither revenue nor rental income, provided that it does not relate to a promised separate performance obligation of the owner. It represents a deduction from the total redevelopment cost to the property owner, similar to a discount, and it should be deducted from the total property cost.

<p>Example – Development contracts: treatment of 'interest' or 'licence' fee</p>
<p>Background</p> <p>Entity A acquired a real estate property, and has decided that the property needs to undergo redevelopment activity to continue to be used as investment property. It has entered into a five-year development contract with a developer. Under the terms of the agreement:</p> <ul style="list-style-type: none"> • The property will not generate any rental income from tenants during this period. • The developer will pay a 'licence' fee to entity A over the five years as compensation for the loss of rental income. • The fee is calculated based on a rental yield. • The fee is invoiced on a typical rental payment date, but remains unpaid. • The developer will deduct the total fee from the final payment due from entity A to the developer. <p>How should entity A account for the fee income?</p> <p>Solution</p> <p>The fee income is part of the negotiated cost for the redevelopment of the property. The income should be recognised as a deduction from the cost for the redevelopment of the property.</p>

2.8. Loan investments in subsidiaries, joint ventures and associates

Entities might make investments in subsidiaries, joint ventures and associates as a method of acquiring direct/indirect interests in investment properties. These investments might be made using a mix of equity and debt finance. The accounting treatment for any equity investment would follow IAS 27 in separate financial statements, and IFRS 10 (for subsidiaries) or IAS 28 (for joint ventures and associates) in consolidated/economic interest financial statements. However, any debt finance provided through repayable loans would fall within the scope of IFRS 9. The guidance within IAS 32 should be considered in determining whether an instrument meets the definition of debt or equity.

2.8.1. Accounting at initial recognition

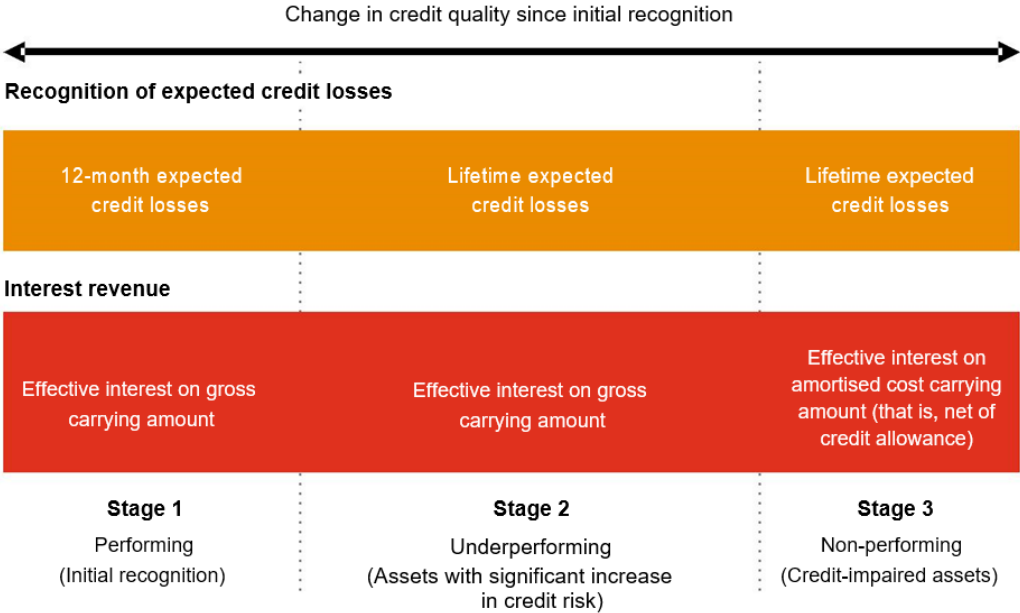
Intra-group loans made to subsidiaries within the scope of IFRS 9, and loans to joint ventures and associates ('funding'), are required to be measured at fair value on initial recognition. Funding might sometimes be either interest-free or provided at below-market interest rates. In those cases, the amount lent is, therefore, not fair value.

Funding at below-market or nil-interest rate is not advanced at fair value. Practically, this means that the cash advanced will not be the receivable recorded. Instead, the receivable will be recorded at a lower amount, to take into account the impact of discounting at a market interest rate.

A day 1 difference arises between the cash advanced and the recorded receivable. If the funding is advanced from a parent entity to its subsidiary, this difference is added to the cost of investment in the subsidiary, because it is the nature of the relationship that gives rise to the off-market/interest-free loan. For loans to joint ventures and associates, this difference would also generally be added to the cost of investment, since the relationship between the investor and the joint venture or associate is often the reason for the loan being off-market/interest-free.

2.8.2. Impairment considerations

The impairment model in IFRS 9 is based on a forward-looking, expected credit loss ('ECL') impairment model outlined further below:



- Stage 1 includes financial instruments that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date. For these assets, 12-month ECLs are recognised and interest revenue is calculated on the gross carrying amount of the asset.
- Stage 2 includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but are not credit-impaired. For these assets, lifetime ECLs are recognised, and interest revenue is still calculated on the gross carrying amount of the asset.
- Stage 3 consists of financial assets that are credit-impaired (that is, where one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred). For these assets, lifetime ECLs are also recognised, but interest revenue is calculated on the net carrying amount (that is, net of the ECL allowance).

Impairment: Intra-group loans and loans to joint ventures and associates

IFRS 9 contains simplifications to this model for certain types of receivable; however, intra-group loans and loans to joint ventures and associates do not qualify for these simplifications. As such, the full impairment model needs to be applied and a 12-month ECL will be recorded on the day when funding is advanced. The impact of IFRS 9 on intra-group funding might often be dismissed, because it is eliminated on consolidation. However, the impact in separate financial statements could be significant.

Subsequently, if there is a significant increase in credit risk (for example, if the trading performance of the subsidiary, joint venture or associate declines), the impairment loss will be increased to a lifetime ECL.

In order to apply the above model, entities will need to ensure that they implement adequate processes for collection of the information needed for impairment. For example:

- Indicators for a significant increase in credit risk must be developed.
- Forward-looking information, as well as past events, must be incorporated.
- The contractual period over which to assess impairment might not be clear.

3. Subsequent measurement of investment property

The standard permits an entity to adopt either the fair value model or the cost model as its accounting policy for subsequent measurement of investment property. The policy selected must be applied to all of the entity's investment property, irrespective of whether the properties are owned or held under a lease. [IAS 40 para 30].

3.1. Costs incurred after initial recognition

Subsequent expenditure should be recognised in the carrying amount of the investment property if it is expected to produce future economic benefits to the entity and its costs can be reliably measured. [IAS 40 para 16].

Such costs are usually capitalised within the carrying amount of an investment property where they increase the investment property's originally assessed standards of performance.

If an entity acquires a property that requires renovation, the price and initial carrying amount would reflect this and would be lower than the cost of a fully renovated property. The cost of renovation work would be capitalised when incurred, because the renovation costs give rise to additional future economic benefits.

Investment property often includes parts, such as lifts or an air-conditioning system, which have shorter useful lives than the rest of the property and might require regular replacement. The replacements give rise to future economic benefits, because the carrying amount takes into account the loss of economic benefits from the deterioration of the originally acquired assets, and the new assets give rise to new economic benefits. Parts that require regular replacement are often called 'components', and the accounting applied to them is referred to as the 'component approach' (see section 3.3.2).

Subsequent costs of day-to-day servicing and maintaining a property are not recognised as an asset. Instead, they are expensed as incurred. Such costs normally include costs of labour and consumables and the cost of replacing minor parts. They are normal repairs and maintenance and, as such, they do not meet the criteria for recognition as an asset, because they do not add future economic benefits. [IAS 40 para 18].

A provision for such subsequent expenditure should be recognised only when an entity has a present obligation, an outflow of resources is probable, and a reliable estimate can be made of the amount of the obligation.

[IAS 37 para 14].

Example – Provision for repair and maintenance

Background

Entity L has acquired an investment property for C100. The building's sewage system was not operating, and entity L decided to incur the minimum expenditure that would make the sewage system operational (which is C5), and to undertake major upgrade of the system at the end of year 5.

Entity L uses the cost model and is proposing to initially recognise this investment property at C115 (being cost of C100, expenditure of C5, and the present value of the planned expenditure at the end of year 5 of C10).

Can an investment property entity establish a provision for planned major expenditure on an investment property?

Solution

No. A provision should be recognised when:

1. an entity has a present obligation;
2. an outflow of resources is probable; and
3. a reliable estimate can be made of the amount of the obligation.

The major maintenance expenses that will arise at the end of year 5 do not meet the definition of a present obligation, so a provision in accordance with IAS 37 cannot be established

Entity L should recognise the investment property at C100 and will capitalise the C5 expenditure to make the sewage system operational when incurred, as this expenditure is expected to produce future economic

benefits over five years as the building can only be used with an operational sewage system. The sewage system component, should be depreciated over five years. At the end of year 5, when the sewage system will be replaced, C10 will be capitalised and depreciated over its useful life.

3.2. Replacement of parts of investment property and subsequent expenditure

Subsequent expenditure on an investment property is added to the investment property's carrying amount when it is probable that future economic benefits will flow to the entity. All other subsequent expenditure is expensed in the period in which it is incurred. [IAS 40 paras 16 - 18]. The cost of a replacement part is recognised as an asset, and the carrying amount of the replaced part is derecognised. This applies irrespective of whether the cost method or the fair value method is used. [IAS 40 para 68]. However, where the fair value model is used, it needs to be carefully assessed whether the fair value already reflects the loss in value of the part to be replaced, or whether it is too difficult to discern how much fair value should be reduced for the parts being replaced. An alternative approach could be used which allows for the cost of the replacement to be included in the carrying amount of the asset and for the fair value to be reassessed afterwards. [IAS 40 para 68].

Under the cost method, it is compulsory to recognise every replacement of a part, and derecognise the replaced part, if the recognition criteria are met. It is not relevant whether a replacement was planned or not. For example, the unplanned replacement of a significant portion of the windows of a building should not be treated as a repair expense. The carrying amount of the replaced windows is derecognised, and the cost of the new windows is recognised.

The significance of the cost of the part, compared to the cost of the total item, is not a criterion for determining the parts of a building for recognition and derecognition purposes. Significance is relevant for the identification of the parts that need to be depreciated separately where the cost model is applied. [IAS 16 para 43]. (See section 3.3.2.1.)

Where the cost model is applied, management should document the historical cost of the parts of a building that are not depreciated separately. An entity should derecognise the carrying amount of a replaced part, regardless of whether the replaced part had been depreciated separately or not. [IAS 16 para 70]. In order to ensure the correct derecognition of replaced parts, the entity might need to determine the carrying amount of the replaced parts. To do so, the entity depreciates the historical cost of each part over its useful life.

If it is not possible to determine the carrying amount of the replaced part based on historical cost, the cost of a replacement might be a good indication of the cost of the replaced part at the time when it was acquired or constructed. [IAS 16 para 70].

Example – Change of a roof: cost model

Background

Entity A acquired an investment property on 1 January 20X0. During 20X9, entity A spent a significant amount of money to install a modern upgraded glass roof on this property. Management believes that it is important for the property to have a modern roof system, to attract and retain tenants and resist downward pressure on rents. It also enables management to reduce electricity costs.

Entity A's management would like to capitalise the expenditure.

Can subsequent expenditure on investment properties carried at cost be capitalised if it enhances the property's future income-earning potential?

Solution

Yes. The roof is usually replaced during the life of a building. The new roof should be capitalised. It is considered likely that the new roof will provide future economic benefits for entity A. The existing roof must be derecognised. The roof of a building is a separate component of the building, and it should be depreciated separately. [IAS 16 para 43].

Example - Change of a roof: fair value model

Background

The facts are as in the above example, except that entity A applies the fair value model to its investment properties. Entity A did not establish the components of the investment property, and it concluded that it is not possible to determine the amount by which the fair value should be reduced for the roof to be replaced.

Can subsequent expenditure on an investment property carried at fair value be capitalised if it enhances the property's future income-earning potential?

Solution

Yes. Subsequent expenditure relating to an investment property is added to the investment property's carrying amount where it is probable that future economic benefits will flow to the entity. All other subsequent expenditure is expensed in the period in which it is incurred. [IAS 40 paras 16 - 18]. The new roof should be capitalised, because it is considered likely to provide future economic benefits for entity A. On the next reporting date, the building's new fair value will be assessed, and any gains/losses will be adjusted accordingly through the income statement. Under this approach, there is no need to derecognise the existing roof or to establish the components of an investment property carried at fair value.

3.3. Subsequent measurement: cost model

Entities that choose the cost model should apply the requirements in IAS 16 for property, plant and equipment measured at cost. Investment properties that meet the criteria to be classified as held for sale, or that are included in a disposal group that is classified as held for sale, should be measured in accordance with IFRS 5 (see [section 6](#)).

3.3.1. Depreciation

Under the cost model, an entity will need to separately depreciate each component part of investment property which is significant in relation to the total cost of the property.

Depreciation should be recognised over the useful life of each individual component. Further guidance on depreciation under the cost model can be found in the [PwC Manual of Accounting chapter 22 paragraphs 79–102](#).

3.3.2. Component approach and depreciation

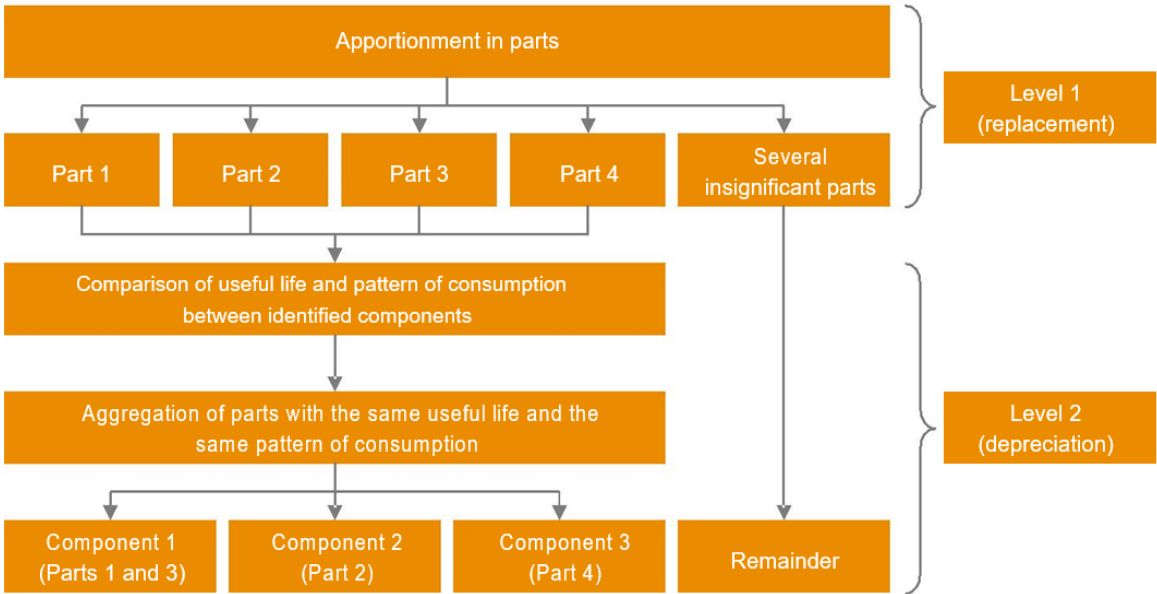
Under the component approach, each part of an investment property with a cost that is significant in relation to the total cost of the property is depreciated separately.

The objective of the component approach is to reflect more precisely the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

To apply the component approach, it is necessary to identify the various parts of an asset. There are two reasons for identifying the parts: depreciation; and the replacement of parts. IAS 16 requires separate depreciation only for significant parts of an item of property, plant and equipment with different useful lives or consumption patterns. However, the principles regarding replacement of parts (that is, subsequent cost of a replaced part) apply generally to all identified parts, regardless of whether they are significant or not.

On replacement of a part, the remaining book value of the replaced part is derecognised, and the cost of the new part is recognised, irrespective of whether the part was depreciated separately or not. Further guidance on the depreciation of components can be found in the [PwC Manual of Accounting chapter 22 paragraphs 85–87](#).

The diagram below illustrates the steps required by the 'component approach'.



3.3.2.1. Identification of significant parts of an asset

The significance of a part of a building for depreciation purposes is determined based on the cost of the part in relation to the total cost of the building at initial recognition. [IAS 16 para 43].

The standard is silent on how to determine the parts of a building. The asset’s specific circumstances need to be taken into account.

Separation between interior and exterior parts would normally not be sufficient for all types of building and across all regions, depending on the type of building.

Management should carefully evaluate whether separation into interior and exterior truly reflects the significant parts of the building, taking into account the need to make replacements during the useful life of the building. For example, solid walls, floors and ceilings can be used over a longer term, and they can be replaced later than plasterboard walls and the heating system.

In practice, the first step in determining the parts of a building should be analysis of the construction contracts, the inspection report or the invoice (being parts of the acquisition cost). If these documents do not provide sufficient information, other sources such as construction catalogues should be taken into account. For construction catalogues to be a sufficient source, they need to be a standard that is commonly used in the economic environment in which the entity operates. It would be expected that such standards take into account the specifics of the geographical area as well as type of building.

It might be necessary to request an expert opinion (for example, construction experts) in order to determine the parts of a building.

The following practices are commonly used to identify the parts of a building:

Example practice 1	Example practice 2
<ul style="list-style-type: none"> • Exterior walls • Interior walls • Windows • Ceiling • Roof • Staircase • Lifts • Air-conditioning system • Heating system 	<ul style="list-style-type: none"> • Structural design • Membrane • Exterior doors and windows • Interior walls, doors and windows • Heating and other technical systems • Sanitary facilities

Example practice 1	Example practice 2
<ul style="list-style-type: none"> • Water system • Electrical system • Major inspections 	

3.3.2.2. Replacement of parts

When a part of an asset is replaced and the recognition criteria are met, the entity needs to derecognise the carrying value of the replaced item and recognise the cost of the replacement (see section 3.2).

Note that, for insignificant parts that are replaced, the carrying amount of the replaced parts should be derecognised, regardless of whether the replaced part had been depreciated separately. [IAS 16 para 70].

3.3.2.3. Depreciation principles

Determining the useful life of the building

An entity is required to estimate the useful life of a building as a whole, in addition to estimating the useful lives of the parts of the building. The entity might include, in its accounting manual, guidance on how the useful life of a building as a whole is estimated.

An entity should estimate the useful economic life of the building, to ensure that the individual useful economic lives of the individual components are reasonably determined within the context of the overall utility of the building to the entity.

Management should estimate the useful life of a building as a whole on a stand-alone basis, taking into account only the expected utility to the entity. [IAS 16 para 57]. The average of the useful lives of the parts is not a sufficient basis to estimate the useful life of the building as a whole.

However, to estimate the useful life of the building as a whole, it might be necessary to consider the useful life or the economic life of significant parts, and whether these parts are so significant that they could affect the useful life of the building as a whole. Management should carefully evaluate situations where the useful life of a building is considered to be longer than the useful life of the structure of the building, such as the walls and roof. Further guidance on the determination of useful life can be found in the [PwC Manual of Accounting chapter 22 paragraphs 88–90](#).

Determining the useful life of significant parts

The cost of a part is depreciated on a systematic basis over its useful life. The asset management policy of the entity might involve disposal of significant parts after a specified time, or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of the asset could be shorter than its economic life. The estimation of useful life is a matter of judgement, based on the entity's experience with similar assets.

An entity should review the useful life (and the residual value) of an asset at least at each financial year end. However, an entity can choose to evaluate the estimated useful life of an asset additionally at each interim reporting date. [IAS 16 para 51].

In principle, the useful life of a part of a building should not be longer than the useful life of the building as a whole. For example, it would be unlikely for a building with a useful life of 25 years to have interior walls with a useful life of 30 years. However, an entity should carefully assess whether parts might be transferred to another building for further use. In those cases, the useful life of the parts might reasonably be longer than the useful life of the building as a whole.

Significant parts can be grouped and depreciated together if their useful life and the depreciation method are the same. [IAS 16 para 45].

Determining the useful life of the remainder

An entity is obliged to depreciate significant parts of a building and the 'rest of the building' separately. The 'rest of the building' consists of parts that are not individually significant. An entity groups these parts to one depreciation unit: the 'remainder' (see the diagram in section 3.3.2).

The remainder consists of those parts of the building that are not individually significant but could have a useful life significantly different from the useful life of the building as a whole.

The applicable useful life of the remainder, as well as the depreciation method used, needs to be determined in a way that faithfully represents the consumption pattern and/or useful life of its parts. [IAS 16 para 46]. One

acceptable method to determine the useful life of the remainder could be the average of the useful life of its parts, rather than the useful life of the building as a whole.

The standard is silent on whether one remainder is sufficient where the useful lives of insignificant parts differ significantly (for example, parts with five years and parts with 20 years of useful life). In such a case, it would be appropriate to have more than one remainder. Further, applying a depreciation rate – calculated based on the average useful life of the parts in the remainder – in that instance might not faithfully represent the consumption pattern and/or the useful life of the parts. [IAS 16 para 46].

3.4. Impairment

3.4.1. Overview

Under the cost model, investment properties should be tested for impairment whenever indicators of impairment exist. Impairment is recognised if the carrying amount of an asset or a cash-generating unit (CGU) exceeds its recoverable amount, which is the higher of fair value less costs of disposal and value in use.

A CGU is defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. [IAS 36 para 6]. Management needs to define the CGU at an appropriate level. In the case of investment property, it is likely that an individual investment property, and its associated assets, would meet the definition of a CGU, since it is usually able to generate independent cash inflows.

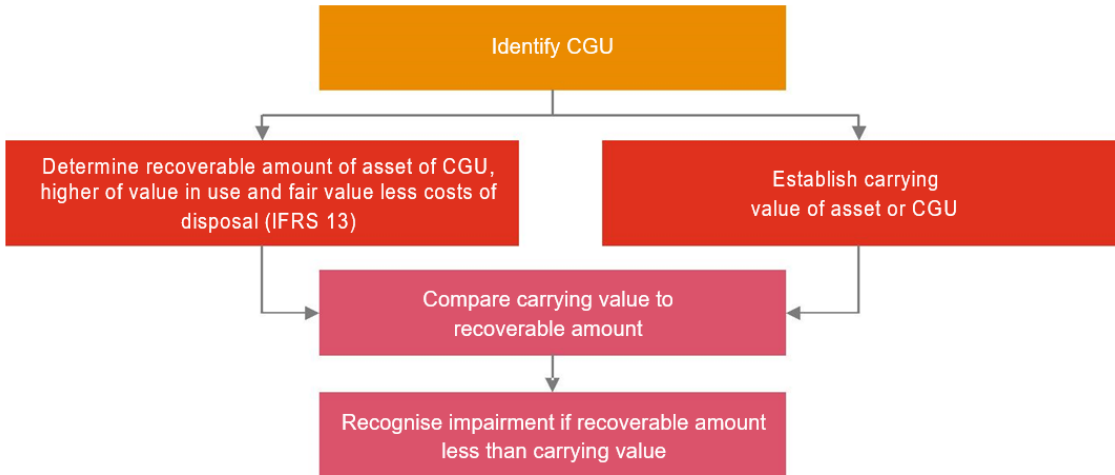
Impairment indicators relevant to the real estate sector include, but are not limited to:

- decline in property prices;
- decline in market rental prices;
- decline in the share prices for property companies;
- market oversupply of properties;
- decline in building permits, in the event that this limits the options for use of the property;
- unfavourable changes in market interest rates;
- increase in country risk;
- cost overruns for property under construction;
- newly constructed properties that might be more attractive to existing tenants of an entity's property; and
- physical or other damage caused to the property.

Properties measured under the fair value model are not tested for impairment.

An impairment test is performed for investment property under construction, accounted for at cost in accordance with IAS 40, where there is an indication (triggering event) that the property is impaired. At each reporting date, management assesses whether there is a triggering event, irrespective of whether cost accounting is a result of management's decision to apply the cost model or due to the fact that fair value cannot be determined reliably in accordance with paragraph 53 of IAS 40.

The impairment process in accordance with IAS 36 is illustrated in the diagram below:



3.4.2. Impairment of individual assets and CGUs

IAS 36 requires a bottom-up, rather than a top-down, approach for impairment testing, and the order in which the testing is performed is crucial.

First, any individual CGUs with indicators of impairment must be tested, and any impairment loss must be recorded in the individual CGU.

The bottom-up approach is applied where there are indications of impairment for individual assets. If those assets do not generate independent cash flows (that is, they are not individual CGUs), they need to be grouped with other assets to determine the CGU (that is, the lowest level at which independent cash inflows arise).

For the purposes of testing goodwill, indefinite-lived intangible assets and corporate asset CGUs might need to be grouped together. The amended carrying values of any individual CGUs that have been adjusted for an impairment charge are used as part of this impairment test. Impairment testing for goodwill is specifically considered in section 3.4.5. It is therefore important to test the individual properties (or CGUs in which the properties are included) for impairment first of all, before testing goodwill for impairment.

If the impairment test shows that the recoverable amount of the group of CGUs exceeds the carrying amount of that group of CGUs, there is no impairment to recognise. However, if the recoverable amount is less than the combined carrying value, the group of CGUs is impaired.

Where goodwill is allocated to the group of CGUs, the impairment charge is allocated first to the goodwill balance to reduce it to zero, and then pro rata to the carrying amount of the other assets within the group.

Example – Investment properties measured using the cost model: portfolio basis
<p>Reference to standard: IAS 40 Industry: Real Estate</p>
<p>Background</p> <p>Entity A is a real estate entity that holds real estate properties with only one operating segment. It purchases a portfolio of investment properties at an amount higher than the aggregated amount of the individual assets’ fair value. The portfolio does not constitute a business. However, entity A intends to manage the portfolio together, and it has a clear plan to dispose of the portfolio as a whole in the future.</p> <p>Management accounts for investment properties using the cost model.</p> <p>Can entity A test the portfolio of assets, whose carrying value is higher than its fair value, for impairment on a portfolio basis?</p> <p>Solution</p> <p>No, each property is a CGU, and so it should be separately tested for impairment.</p>

3.4.3. Calculating the recoverable amount

The recoverable amount is computed as the higher of value in use and fair value less costs of disposal. Fair value assumes recovery of the asset through its sale. Fair value is an objective, market participant, value, which is independent from the specific company, where market prices and market information are incorporated in its determination. Further guidance on fair value measurement is contained in [section 3.6](#).

Value in use assumes recovery of the asset through its use. Value in use is an entity-specific measure, determined in accordance with the entity's view of use of the investment property. It is a present value measure, in which cash flows incorporate the estimates of the entity rather than the market. Nevertheless, an entity should place greater reliance on market data and corroborate its estimates with external information.

3.4.4. Key considerations when estimating value in use

3.4.4.1. Cash flows

Cash flow forecasts should be based on the latest management-approved budgets or forecasts for the investment property. Assumptions made in the cash flows should be reasonable and supportable. [\[IAS 36 para 33\]](#). For example, cash flows should be derived by contractual agreements, and they should take property yields into consideration. They should represent management's best estimate of the economic circumstances that will prevail over the remaining life of the property.

Greater weight should be given to external evidence. For example, the cash flows/forecasts should be compared with external information, such as analysts' reports, the views of other third party experts and economic forecasters.

3.4.4.2. Carrying amount: like with like

Cash flows being used in the recoverable amount should be consistent with the assets being tested in the carrying amount of the CGU. The impairment test should compare like with like. Working capital and tax are two key areas to consider.

IAS 36 permits cash flows from the settlement of working capital balances to be unadjusted if they are included in the budgets/forecast, provided that the carrying value of the CGU is increased/reduced by the amount of the working capital assets/liabilities. Assets arising from incentives or prepayments should be carefully considered, to avoid double counting.

Cash flow forecasts should exclude cash flows relating to financing (including interest payments). Cash flows should exclude cash flows relating to tax losses, because these do not affect the recoverable amount of the CGU being tested. Current and deferred taxes are excluded from value in use cash flows. [\[IAS 36 para 50\(a\)\]](#).

When assessing impairment for any leased investment properties, cash flows should exclude lease payments if they are captured as part of the lease liability. The discount rate would be impacted as a result of the inclusion of the lease liability, which will increase the debt to equity ratio.

3.4.4.3. Terminal value

Cash flows are projected over the life of the property. If the investment property is part of a CGU with an indefinite life, a terminal value is required in the cash flow forecast. This represents what an investor might pay for the cash flows beyond the specific forecast period.

This is usually calculated using a perpetuity formula which takes the last year of cash flows into consideration. Careful consideration is needed as to whether the business is cyclical. It is important to ensure that the forecast period is long enough to achieve normalised growth and margin levels.

The long-term growth rate should be reasonable in comparison to long-term inflation expectations. Nominal long-term growth rates in excess of long-term nominal GDP growth imply that the business will eventually grow larger than the economy itself. This is unlikely to be appropriate.

3.4.4.4. Discount rates

The discount rate used is the rate that reflects the specific risks of the investment property or the CGU to which it relates. Different CGUs might warrant different discount rates (for example, properties held in different countries are likely to be subject to different political and currency risks).

The discount rate should not be adjusted for risks that have already been considered in projecting future cash flows. Management should also consider country risk, currency risk and cash flow risk.

Value in use is calculated on pre-tax cash flows using a pre-tax discount rate.

3.4.5. Special considerations: goodwill impairment for real estate entities

3.4.5.1. Testing goodwill on a portfolio basis

Goodwill is tested for impairment at least annually, where there is an indicator that it is impaired or where there is an indicator that the CGU(s) to which it is allocated is impaired. Where the impairment indicator relates to specific CGUs, those CGUs are tested for impairment separately, before testing the group of CGUs and the goodwill together.

Goodwill is tested at the lowest level at which it is monitored by management. The lowest level cannot be higher than the operating segment as defined in IFRS 8 (see section 8.2).

If management monitors goodwill on an individual CGU basis, testing goodwill for impairment should be performed on that individual basis. However, where management monitors goodwill based on a group of CGUs, the impairment testing of the goodwill should reflect this.

Example – Testing of goodwill arising on a business combination on a portfolio basis

Background

Entity A is a real estate entity that holds investment properties with only one operating segment. It purchases a portfolio of investment property at an amount higher than the aggregated amount of the individual assets' fair value. The portfolio is an individually managed portfolio and constitutes a business.

Entity A recognises each identifiable asset at its fair value at the date of acquisition. [IFRS 3 para 18]. The entity first considers whether the premium has been paid to gain control over any other identifiable and reliably measurable intangible assets, and then the remaining difference is accounted for as goodwill in accordance with paragraph 32 of IFRS 3. Goodwill is monitored at the portfolio level. Entity A needs to test the recognised goodwill annually for any impairment.

At which level should goodwill be tested?

Solution

The portfolio is the group of CGUs that represents the lowest level at which the entity monitors the goodwill, and it cannot be higher than the operating segment level. Therefore, the goodwill is tested on a portfolio basis, and the recoverable amount of the portfolio needs to be considered, to determine whether or not goodwill is impaired. This would apply equally to companies applying the fair value model and the cost model.

3.4.5.2. Goodwill arising from deferred tax

Where a property acquisition meets the definition of a business, the entity should apply IAS 12, and it might need to recognise a deferred tax liability on acquisition. The corresponding debit entry will increase goodwill.

Deferred tax liabilities on investment properties in a business combination might be significant, because there might be no tax deduction for these assets. This leads to the recognition of a higher amount of goodwill.

A value in use calculation, which is a pre-tax value, might indicate an impairment charge soon after an acquisition is made, due to the higher amount of goodwill that is recorded as a result of recognising a deferred tax liability.

In order to address this anomaly, a test should be performed using fair value less costs of disposal. The fair value less costs of disposal is a post-tax measure of recoverable value. The carrying value of a CGU under the fair value less costs of disposal method should include the deferred tax liabilities. The comparison of discounted post-tax cash flows and the CGU's carrying value, including deferred tax liabilities, might eliminate or reduce the amount of any impairment charge.

3.5. Subsequent measurement: fair value model

An entity that chooses to apply the fair value model for its investment property measures its properties at fair value, with any resulting gain or loss being recognised in the income statement. The measurement of fair value of investment properties is within the scope of IFRS 13. Fair value measurement is a market-based measurement. It is the price that would be received to sell an asset in an orderly transaction between market participants. Market participants are independent, knowledgeable buyers that would be willing to transact with the entity in an orderly transaction.

Management measures the property at fair value until disposal or change in use (for example, the property becomes owner-occupied, see section 3.7.1), even if comparable market transactions become less frequent or market prices become less readily available. [IAS 40 para 55]. In this case, management uses alternative

valuation methods, such as discounted cash flow projections. [IAS 40 para 46(c)]. It is prohibited to change from the fair value model to the cost model. [IAS 40 para 31; IAS 8 para 14(b)].

3.5.1. Application where fair value cannot be determined on a continuous basis

Fair value measurement is applied if the fair value is considered to be reliably measurable. [IAS 40 para 53]. The general presumption for investment properties, including properties under construction, is that fair value can be reliably determined. [IAS 40 para 53]. This presumption can only be rebutted on initial recognition. [IAS 40 para 53B]. We would expect rebuttal of this presumption to be rare.

The fair value of the investment property is not reliably determinable on a continuing basis only where comparable market transactions are infrequent and alternative reliable estimates of fair value (that is, based on discounted cash flow projections) are not available. [IAS 40 para 53]. Where there is a clear expectation or other evidence that the market transactions are not orderly, little if any weight should be placed on the expected disorderly transaction prices. [IFRS 13 App B para B44]. Where an entity does not have sufficient information to know if the market transactions are orderly, the anticipated transaction prices should be taken into account, but it will be given less weight than those market transactions known to be orderly. Once an investment property has been measured at fair value, it continues to be measured at fair value, even if comparable market transactions become less frequent or unavailable.

Excluded from the fair value measurement requirement are investment properties for which:

- the fair value cannot be reliably determined whilst the property is under construction, but for which the entity expects the fair value to be reliably determinable when construction is completed; or
- in exceptional cases, there is clear evidence, when an entity first acquires or initially recognises the investment property, that the fair value cannot be determined reliably on a continuing basis.

In order to evaluate whether the fair value of an investment property under construction can be determined reliably, management considers the following factors, among others:

- The provisions of the construction contract.
- The stage of completion.
- Whether the project/property is standard (that is, typical for the market) or non-standard.
- The level of reliable information as to cash inflows after completion.
- The development risk specific to the property.
- Past experience with similar developments.
- The status of construction permits.

In the event that the presumption that fair value can be reliably determined is rebutted for investment property under construction, management applies the cost model in accordance with IAS 16 for that property (or IFRS 16 where the investment property is held by a lessee as a right-of-use asset and IFRS 16 has been adopted). However, the property is required to be measured at fair value at the earlier of the date when a reliable fair value can be determined for the property and the date when construction is completed. [IAS 40 para 53A]. Once a property has been measured at fair value, the entity cannot later conclude that the fair value of the property cannot be determined reliably. [IAS 40 para 53B].

In the rare event that the fair value of a property that is not a property under construction cannot be reliably determined on a continuing basis, management:

- a. applies the cost model in accordance with IAS 16 for that property [IAS 40 para 53] (or IFRS 16 where the investment property is held by a lessee as a right-of-use asset and IFRS 16 has been adopted); and
- b. accounts for its remaining investment properties at fair value, if their fair value can be determined reliably.

An entity continues to apply IAS 16 (or IFRS 16) until the investment property is disposed of. The property cannot subsequently be measured at fair value.

3.5.2. Fair value measurement of assets held in corporate wrappers in consolidated financial statements

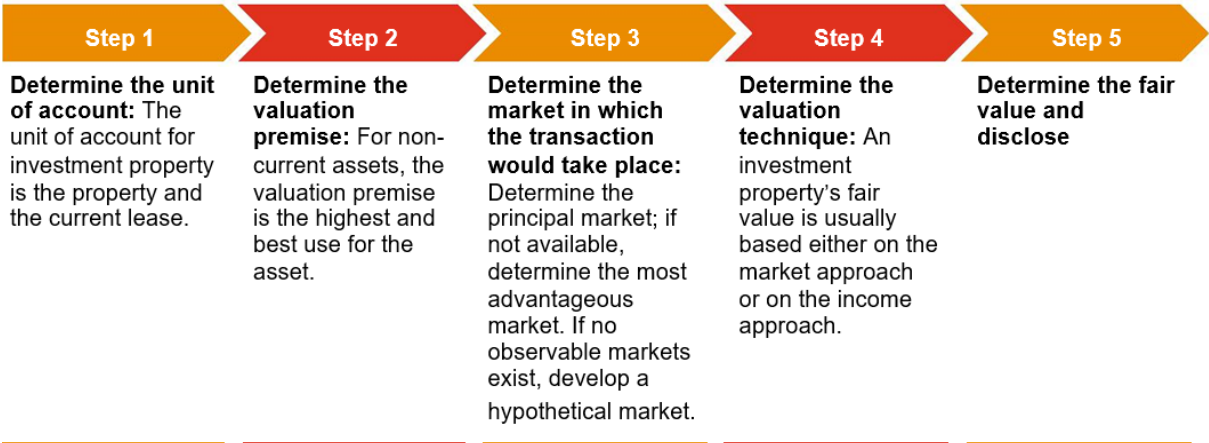
Entities might carry an investment property in a separate legal entity (that is, a corporate wrapper). Usually, this structure is used for tax purposes, as quite often it is more tax beneficial for the entity to sell the corporate wrapper rather than the underlying property itself. The implications of such structures for the recognition of deferred tax are discussed in [section 5.3.6](#).

Similar to the accounting for deferred tax, for the purposes of consolidated financial statements, there is no guidance on how to determine fair value of investment properties where they are held in corporate wrappers. In our view, management should determine fair value based on the underlying investment property itself, which is the unit of account for consolidated financial statement purposes, and not by reference to the expected sale of the property in a corporate wrapper. The fair value should exclude any benefits from the legal structure. For further guidance on the unit of account, see [section 3.6.2](#).

3.6. Fair value measurement of investment property: IFRS 13

3.6.1. Overview

As mentioned in [section 3.5](#), entities look to the guidance in IFRS 13 in determining fair value. Fair value is the price that would be received to sell an asset in an orderly transaction between market participants. A fair value measurement takes into account the characteristics of the asset. Applying this to real estate, those characteristics could be the condition and location of the asset, and restrictions on its use. The overall fair value approach in IFRS 13 is summarised in the following diagram:



3.6.2. Principal market and unit of account for investment property

IFRS 13 requires management to identify the relevant market in which a typical transaction of the asset would take place. A fair value measurement assumes that the transaction to sell an asset takes place in the principal market for the asset or, in the absence of a principal market, in the most advantageous market for the asset. The principal market is the market with the greatest volume and level of activity for the asset or liability that can be accessed by the entity.

In the absence of evidence to the contrary, the market in which the entity would normally enter into a transaction to sell the asset or to transfer the liability is presumed to be the principal market or, in the absence of a principal market, the most advantageous market. However, management does not need to continuously monitor different markets to identify the most advantageous market at the measurement date.

The identification of the principal market requires, first, the identification of the unit of account which is subject to transactions in this market. IFRS 13 refers to the unit of account as it is defined by the respective IFRS that requires or permits fair value measurement:

Fair value measurement: unit of account	
Unit of account for investment properties is defined according to IAS 40	'Whether the asset or liability is a stand-alone asset or liability, a group of assets, a group of liabilities or a group of assets and liabilities for recognition or disclosure purpose depends on its unit of account. The unit of account for the asset or liability shall be determined in accordance with the IFRS that requires or permits the fair value measurement, except as provided in this IFRS'. [IFRS 13 para 14].

According to paragraph 5 of IAS 40, 'investment property is property (land or 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'. As a result, the unit of account – the single property (for example, land and building) – is the relevant level at which to measure an investment property.

IFRS 13 allows fair value to be determined in combination with other assets, where this would result in the highest and best use of the asset. The fair value might be the same, whether the asset is used on a stand-alone basis or in combination with other assets. This conclusion is based on the assumption that the use of the assets as a group in an ongoing business would generate synergies that would be available to market participants.

As a result, market participants would judge the synergies on a stand-alone basis, as well as in an asset group on the same basis. However, for real estate assets, the valuation of the investment property is almost always on a stand-alone basis. Only in extremely rare circumstances 'the entity might measure the asset at an amount that approximates its fair value when allocating the fair value of the asset group to the individual assets of the group'. [IFRS 13 App B para B3(e)].

Sometimes, an entity expects to sell a number of properties together as a portfolio, resulting in a portfolio premium being negotiated for the transaction. However, each investment property should continue to be valued on a stand-alone basis. It would not be appropriate to allocate an expected portfolio premium to the fair value of individual investment properties.

3.6.2.1. Comparing like with like

When determining the fair value of investment property, entities need to avoid double counting of assets or liabilities that are separately recognised in the balance sheet. [IAS 40 para 50].

For example, the impact of prepayments should be considered. If the cash flow projections include the impact of prepayments, the carrying value should include the related prepayment together with the investment property. Conversely, if the cash flows do not include the effect of prepayments, the carrying value should also exclude such impact. Whereas the above principles, if applied correctly, should produce the same answer, the decision to include or exclude certain assets from the valuation might also be driven by regulatory requirements.

Example – Adjustments for prepayments and accruals
<p>Background</p> <p>Entity Z rents a building to third parties under operating leases. It has accrued lease payments of C1 in its balance sheet as a result of certain rent incentives that it gave to its tenants during the first year of the leases.</p> <p>Entity Z uses the fair value model for measuring its investment properties. The valuation of its investment properties is based on discounted cash flows. The fair value of the building at the balance sheet date is C10.</p> <p>Should management adjust the carrying value of a property to avoid double counting of the accrued lease payments?</p> <p>Solution</p> <p>Yes. Management should make an adjustment to the fair value of investment property to the extent of any separately recognised element of revenue not yet received in cash. Fair value calculations will not take into account the fact that an asset has already been recognised for a portion of the future cash flows. The carrying amount of the building is therefore C9, adjusted for the C1 already recognised in the balance sheet.</p>

3.6.3. Valuation premise: highest and best use

The valuation premise for non-current assets is the concept of 'highest and best use'. This is particularly relevant for real estate valuations, because land values depend significantly on the assumptions about the land's potential use.

Fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use, or by selling it to another market participant that would use the asset in its highest and best use. The highest and best use takes into account the use of the asset that is physically possible, legally permissible and financially feasible. [IFRS 13 para 27].

Physical possible	Legally permissible	Financially feasible
Takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (for example, the location or size of a property).	Takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (for example, the zoning regulations applicable to a property).	Takes into account whether the use of the asset generates adequate income or cash flows (taking into consideration the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

An entity's current use of a non-financial asset is presumed to be its highest and best use, unless market or other factors suggest that a different use by market participants would maximise the value of the asset.

In cases where the current use differs from the highest and best use, management should estimate a fair value based on the hypothetical exit price, assuming the asset's highest and best use by market participants. This issue will arise from time to time in the real estate industry, because the way in which an entity uses land sometimes differs from the use of surrounding land.

When determining the highest and best use of a non-financial asset, management should take into account two possibilities: the highest and best use of an asset when used in combination with other assets as a group (as installed or otherwise configured for use); and in combination with other assets and liabilities (for example, a business).

If the highest and best use of the asset is to use the asset in combination with other assets, or with other assets and liabilities, the asset's fair value is the price that would be received, assuming that the asset would be used with other assets, or with other assets and liabilities, and that those complementary assets and liabilities would be available to market participants.

However, the fair value measurement of a non-financial asset assumes that the asset is sold consistently with the unit of account specified in the standard requiring fair value measurement, being IAS 40 in the case of investment property (see section 3.6.2). This is the case, even where the fair value measurement assumes that the highest and best use of the asset is to use it in combination with other assets, or with other assets and liabilities.

The estimation of an exit price is not based on a transaction including the complementary assets and liabilities; it assumes that the market participant already holds the complementary assets and the associated liabilities.

Example – Highest and best use (1)
<p>Reference to standard: IFRS13 Industry: Real Estate</p>
<p>Background</p> <p>A piece of land being developed for industrial use as a site for a factory could be developed as a site for high-rise apartment buildings if there is a future change in legislation (for example, a new zoning).</p> <p>How should management estimate the highest and best use?</p> <p>Solution</p> <p>As a starting point, the current use of land is presumed to be its highest and best use, unless market or other factors suggest a different use. Highest and best use is determined from the perspective of market participants. According to paragraph BC 69 of IFRS 13, 'a fair value measurement can assume a different zoning if market participants would do so (incorporating the cost to convert the asset and obtain that different zoning permission, including the risk that such permission would not be granted)'. See Illustrative Example 2 of</p>

IFRS 13. In this case, there would need to be appropriate supporting evidence that the potential re-zoning would be considered by market participants when determining the fair value. Furthermore, the use of the asset must be physically possible and financially feasible.

Example – Highest and best use (2)

Background

Entity X holds an undeveloped plot of land (without street access) as investment property. In front of the plot, there are industrial sites with street access. There are three companies located next to the undeveloped plot which are strongly in need of additional storage space. For those three market participants, the undeveloped plot – although hinterland – is very valuable, whereas for all others it is all but worthless.

How should management estimate the highest and best use for the purposes of determining its fair value?

Solution

The market participants in the market for the plot are the three industrial companies located next to the plot. The value of the plot would be the exit price that one of the industrial companies would be willing to pay.

3.6.4. Valuation techniques

IFRS 13 sets out three approaches that can be used to derive fair value:

- **The income approach:** under this approach, future amounts are converted into a single current amount using discounted cash flows.
- **The market approach:** under this approach, prices and other information generated by market transactions of similar assets are used to determine fair value.
- **The cost approach:** this approach reflects the amount that would be required to replace the asset.

Management should use valuation techniques consistent with one or more of these approaches. The valuation techniques used should be those that are appropriate in the circumstances and those for which sufficient data is available. Management should use techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs (see further [section 3.6.5](#)). Valuation techniques should be applied consistently. However, a change in the valuation technique or its application can be appropriate if the result is equally or more representative of fair value.

[Paragraph 40 of IAS 40](#) requires fair value to reflect rental income from current leases in addition to assumptions that market participants would use when determining the price of investment property. Market participants would usually estimate the price of an investment property based on their expectations about future income. On that basis, a market or income approach will, therefore, almost always be more appropriate. For specific considerations for property under development, see [section 3.6.6](#).

IFRS 13 encourages an entity to apply multiple valuation techniques if appropriate. In this case, the results (that is, the respective indications of fair value) should be evaluated, considering the reasonableness of the range of values indicated by those results.

The fair value measurement is the amount that is most representative of fair value in the circumstances. This approach obviously requires significant judgement, and the results of the multiple valuation techniques should be evaluated carefully.

3.6.4.1. The income approach

The fair value of an investment property can be measured using discounted cash flow projections based on reliable estimates of future rental income and expenditure, supported by the terms of the existing lease and other contracts. External evidence should also be used, such as current market rents for properties of a similar nature, condition and location. Discount rates that reflect current market participant assessments of uncertainty regarding the amount and timing of cash flows should be used to discount the projected future cash flows.

Using the income approach to measure the fair value of investment property is likely to result in a Level 3 measurement, because the most significant input will be the projected cash flows (see [section 3.6.5](#)).

3.6.4.2. The market approach

The best evidence of fair value is usually provided by current prices in an active market for similar property in a similar location and condition and subject to similar lease terms and other conditions. Clearly, such conditions are not always present, and so an entity should take account of, and make allowances for, differences from the comparable properties in location, nature and condition of the property, or in contractual terms of leases and other

contracts relating to the property. For example, if the property is leased by the entity under a lease that contains restrictions on the uses to which a property can be put by present and future lessees, that could significantly affect its fair value, because it might restrict the entity's ability to obtain the optimum market rentals.

Where current prices in an active market are not available, entities should consider evidence from alternative sources, such as:

- Current prices in an active market for properties of a different nature, condition or location or that are subject to different lease or other contractual terms, adjusted to reflect the differences.
- Recent prices from transactions on less active markets, adjusted to reflect changes in economic conditions since the date of those transactions.

Using the market approach to measure the fair value of investment property might, in some cases, be a Level 2 measurement. If significant adjustments are made to the observable data inputs to the valuation, the measurement will be classified as Level 3 (see [section 3.6.5](#)).

3.6.4.3. Expenditures included in fair value measurement

Fair value measurement of a property requires the use of estimates and judgements.

Estimates and judgements should be made on the basis of a market participant's expectations. A key issue arising, in measuring fair value of investment properties, is whether future capital expenditures for the development of a property should be considered.

As a general rule, such expenditure should be considered only when a market participant would be reasonably expected to consider these in valuing the property.

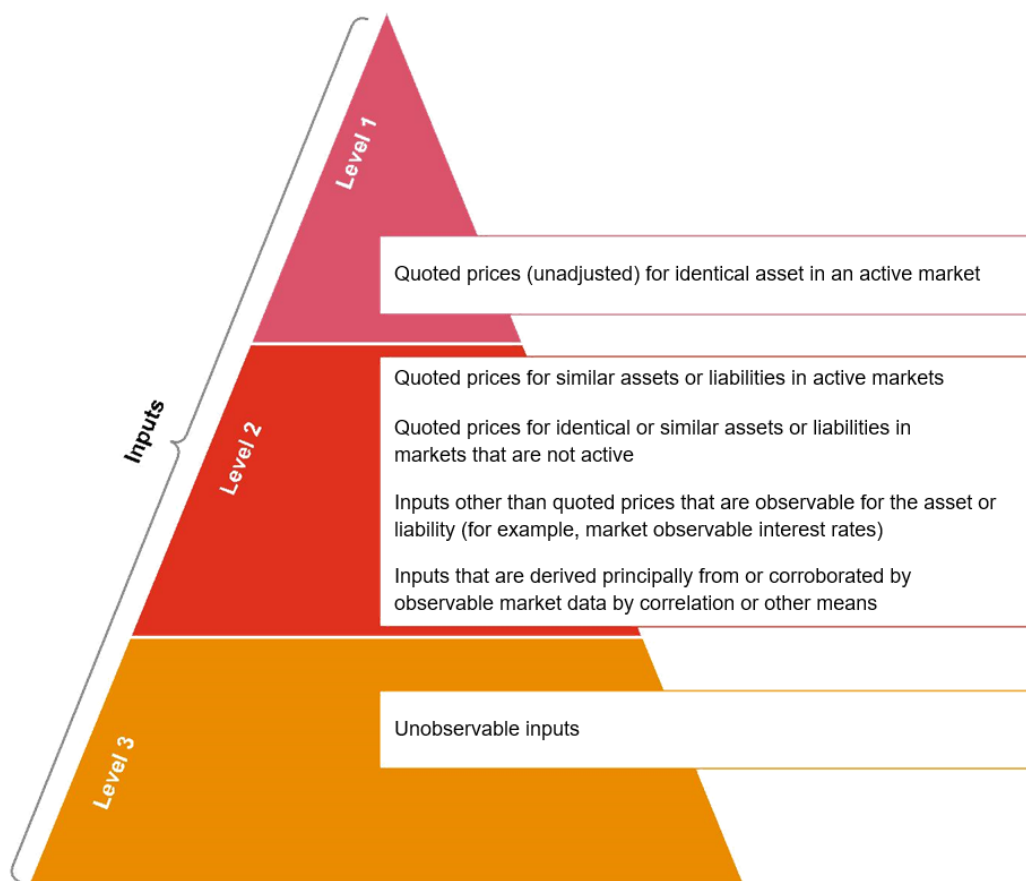
This expectation becomes more prominent for properties under development, in which case a market participant would indeed be reasonably expected to complete the development of the property. In this case, it can be considered that the related expenditure is part of the strategic construction plan for the property.

3.6.5. Fair value hierarchy and valuation inputs

Fair value measurements are categorised into a three-level hierarchy based on the type of inputs. The hierarchy is defined as follows:

- Level 1 inputs are unadjusted quoted prices in active markets for items identical to the asset being measured.
- Level 2 inputs are inputs other than quoted prices in active markets included within Level 1 that are directly or indirectly observable.
- Level 3 inputs are unobservable inputs that are usually determined based on management's assumptions. However, Level 3 inputs have to reflect the assumptions that market participants would use when determining an appropriate price for the asset.

Entities are not free to choose which level of inputs to use; they must select the most appropriate valuation techniques that maximise the use of observable inputs and minimise the use of unobservable inputs. [[IFRS 13 para 61](#)].



In some cases, the inputs used to measure fair value might be categorised within different levels of the fair value hierarchy. In such instances, the fair value measurement is categorised in its entirety based on the lowest level input that is significant to the measurement.

Due to the nature of real estate assets – which are often unique and not traded on a regular basis – and the subsequent lack of observable input data for identical assets, value measurements of real estate will be categorised as Level 2 or Level 3 valuations. All observable market data is given higher priority and should be preferred over unobservable inputs.

The table below gives examples of inputs to real estate valuations and their typical categorisation in the fair value hierarchy:

Level 2 – Valuation inputs	Level 3 – Valuation inputs
<ul style="list-style-type: none"> • Sale prices per square metre for similar properties in similar locations • Observable market rent per square metre for similar properties • Property yields derived from latest transactions 	<ul style="list-style-type: none"> • Yields based on management estimation • Significant yield adjustments based on management’s assumptions about uncertainty/risk • Assumptions about future development or parameters (for example, vacancy, rent) that are not derived from the market • Cash flow forecast using the entity’s own data

The use of unobservable inputs is a complex and judgmental area. An entity should develop unobservable inputs using the best information available in the circumstances. An entity might begin with its own data, but it should adjust that data if reasonably available information indicates that other market participants would use different data, or there is something particular to the entity that is not available to other market participants, such as an entity-specific synergy.

An entity does not need to undertake exhaustive efforts to obtain information about market participant assumptions. It is, however, expected to take into account all information about market participant assumptions that is reasonably available. [IFRS 13 para 89].

So, unobservable inputs should still be adjusted for market participant assumptions, but the information gathered to determine market participant assumptions should be limited to the extent that it is reasonably available. Information that becomes known after the measurement date is only taken into account where reasonable and customary due diligence would have identified the additional information at the measurement date. An entity should revise its fair value estimates if reasonably available information at the measurement date indicates that other market participants would use different data. [IFRS 13 para 89].

When valuing businesses and most non-financial assets, entities in practice use an expected cash flow model. Even if management is not explicitly modelling scenarios, it is implicitly assigning a probability weighting to possible scenarios to arrive at a single forecast. Another approach is to use a forecast that is not an expected cash flow forecast, for example, management's best estimate. IFRS 13 requires the use of a discount rate that is consistent with the risk inherent in the cash flows. This means that the discount rate applied to the expected cash flows and 'best estimate' cash flows are not the same. If the cash flow forecasts do not fully reflect multiple scenarios capturing the range of relevant outcomes, an entity may need to add a company-specific risk premium, also known as an alpha, to the discount rate. This will result in a higher discount rate that reflects the risks in the forecast. A multiple scenario approach may eliminate the need for the alpha adjustment since discount rates should not be adjusted for risks that are already reflected in the cash flows.

If management moves from a single set of cash flows to a probability weighted set of cash flows, this represents a change in accounting estimate in accordance with IAS 8, which should be accounted for as such. However, in accordance with IFRS 13 paragraph 66, the disclosures in IAS 8 for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique or its application. However, IFRS 13 requires that a change in valuation technique is disclosed, along with the reasons for making that change. IFRS 13 paragraph 65 cites changing market conditions as an example of a circumstance where a change in valuation technique or its application may be appropriate.

Additionally, IFRS 13 deals with uncertainty in relation to Level 3 fair value measurements through providing users with appropriate disclosure. For example, including a description of the valuation techniques used, how decisions are made in relation to valuation procedures and for recurring fair value measurements, the sensitivity of fair value measurements to significant unobservable inputs.

3.6.6. Application to developments in progress

Developments in progress are the most challenging, from a valuation perspective, because there is normally very little, if any, market evidence which would be representative of fair value. Forced sales are not viewed as representative of fair value.

The lack of transactions and the property-specific nature of development often rule out the use of a market approach for valuation. Instead, the valuation of development properties is typically based on the expected future cash flows, and so it is effectively an income approach.

The first and perhaps most important step when estimating future cash flows is to identify the optimal development scheme to maximise the value of the site (that is, its highest and best use, as described in section 3.6.3). The estimation of the end value and the development costs will then be based on this conceptual scheme.

It is important that the assumptions made regarding the proposed development scheme are realistic and achievable, having regard to the site constraints, planning restrictions, project economics and market demand. Once the construction phase has started, the future cash flows will normally be based on the actual scheme in progress, unless it clearly fails to deliver optimal value.

In the very early stages of a development project (for example, at the conception/feasibility stage), a question arises as to whether the fair value can be reliably measured (see section 3.5.1) or whether costs incurred to date are representative of fair value. This approach will only be robust in a stable market with constant values where the site was originally acquired at fair value and the major value accretive steps in the development process have yet to begin.

Two common approaches are followed when determining the fair value of property under construction:

1. The static approach (traditional residual method).
2. The discounted cash flow approach (dynamic approach).

3.6.6.1. Static approach (traditional residual method)

The methodology for valuing development properties is reasonably well established in many countries, although it is primarily used for appraising development opportunities prior to acquisition.

Historically, the principal methodology used to value development properties was known as the 'residual method' (alternatively known as the 'static approach'), which is summarised as follows:



This methodology has traditionally been applied using the mathematical formula above, which involves a number of simplifications and needs to be applied with caution. The use of this approach is likely to be most appropriate in the feasibility stages of a project, when the future cash flows have yet to be quantified in detail.

3.6.6.2. Discounted cash flow approach (dynamic approach)

A dynamic discounted cash flow (DCF) method will often be a more robust approach to determine a development property's fair value, compared to the traditional (static) approach.

The inputs into a DCF methodology will typically be more explicit, both in terms of quantification and timing, than those applied in the traditional approach. The net present value derived from the DCF calculation will represent the current value of the development. The internal rate of return will also be visible. It provides a helpful sense check and indicates whether the implied return is commensurate with the risks involved, having regard to other potential investment opportunities with a similar risk profile.

The fair value measured by applying a dynamic valuation approach has to include the developer's profit that has accrued until the valuation date. The estimation of this profit portion should consider the level of risk that has been mitigated until the valuation date, as well as the level of outstanding risk. For example, such an estimation can be based on a risk matrix approach. Nevertheless, the identification and detailed assessment of individual risk factors will arguably be a complex and difficult process.

3.7. Change in use of assets: transfers into and out of investment property

Transfers into, or out of, investment property are made where there is an evidenced change in use. To conclude that there is a change of use, there should be an assessment of whether or not the definition of investment property is met. This change must be supported by evidence. A change in management's intention, in isolation, does not provide evidence of a change in use. [Paragraph 57 of IAS 40](#) provides a non-exhaustive list of examples of when a change in use might be evidenced.

Changes in use of an existing asset are not changes in accounting policies, and so they are accounted for prospectively. [\[IAS 8 para 16\]](#). No changes in comparatives should be made.

3.7.1. Transfers out of investment property

Investment property to owner-occupied property

An investment property is transferred to property, plant and equipment (PP&E) when owner-occupation commences or if the investment property is redeveloped with a view to owner-occupation. [\[IAS 40 para 57\(a\)\]](#). However, if an entity begins to redevelop an existing investment property for continued future use as investment property, the property is not reclassified as owner-occupied property during the redevelopment.

Investment property to inventory

An investment property is transferred to inventory at the time of commencement of development with a view to sale. [\[IAS 40 para 57\(b\)\]](#).

If a property is to be disposed of without development, there has been no change in use, and the property is not transferred to inventory. It is retained as investment property. The property might be reclassified as a non-current asset held for sale and accounted for in accordance with IFRS 5 where the relevant criteria are met (see [section 6](#)).

Example – Property under construction

Background

Entity D is engaged in two lines of business: developing property for sale; and holding real estate property for rental purposes. Two of the properties currently classified as investment property are to be sold in the near future.

Property X is going to be redeveloped prior to sale. The redevelopment will significantly improve and enhance the property. Property Y will also be sold, but significant redevelopment is not necessary, although some basic repairs will be undertaken.

Entity D wishes to transfer both properties from investment property to inventory at the date when the redevelopment and basic repair works commence.

How should entity D account for the properties?

Solution

Entity D should transfer property X to inventory at the commencement of the redevelopment. Property Y should continue to be classified as investment property until the criteria in IFRS 5 are met, at which point the property should be classified as held for sale.

[Paragraph 57\(b\) of IAS 40](#) requires an investment property to be transferred to inventory only when it is being developed with a view to sale. Developments, in this context, should substantially modify or otherwise enhance the property; basic repairs would typically not qualify as a substantial modification.

3.7.2. Transfers into investment property

Property, plant and equipment to investment property

An item of owner-occupied property is transferred to investment property when owner-occupation ceases. [[IAS 40 para 57\(c\)](#)].

Example – Change in use of an existing asset

Background

Entity A owns an office building that it has previously used for its own administrative purposes. The building has been classified as PP&E.

During the year, management moved the workforce to a new building and leased the old building to a third party.

Should the building be reclassified to investment property?

Solution

Yes. The building should be reclassified to investment property when management moves to the new building and owner-occupation ceases. The change represents a change in use of the property, and so no restatement of the comparative amounts should be made. The fact that different accounting treatment is applied to the same property in the current year and the prior year is appropriate, because the building was used for different purposes in the two years.

Inventory to investment property

Property held as inventory is transferred to investment property on commencement of an operating lease with a third party.

A property under construction, that was previously classified as inventory, is not transferred to investment property solely when the intention to sell changes. The inventory will be transferred to investment property when there is a change in use evidenced, for example, by signing an operating lease to lease all or part of the property to a third party. [[IAS 40 para 57\(d\)](#)].

Example – Transfer of inventory (1)

Background

Entity A, a property developer with a history of developing properties for sale immediately after completion, constructs a residential apartment block for sale. It decides to lease out individual apartments when construction is completed, to increase the possibility of selling the entire property after completion. The tenants move in before the property in its entirety is completed and sold. For the purpose of this example, it is assumed that entity A still 'controls' the asset within the meaning of [paragraph 31 of IFRS 15](#).

How should entity A account for the property?

Solution

Entity A should continue to classify the property as inventory, because this is consistent with the entity's principal activities and its strategy for the property, even after the commencement of leases. The leases are intended to increase the possibility of selling the property, rather than to earn rental income on a continuing basis, and the property is not held for capital appreciation.

The entity's intention to sell the property immediately after completion has not changed, because the property continues to be held exclusively with a view to sale in the ordinary course of business; it does not therefore meet the definition of investment property. [\[IAS 40 para 9\(a\)\]](#).

Example – Transfer of inventory (2) Renting until market activity improves

Background

Entity B, a property developer with a history of developing properties for sale immediately after completion, constructs a residential property for sale. However, as property prices are at a multi-year low and there are few buyers/transactions in the market, entity B decides to rent out the property until market activity improves.

How should entity B account for the property?

Solution

Entity B needs to carefully assess whether the property should continue to be classified as inventory or be transferred to investment properties in accordance with [paragraph 57 \(d\) of IAS 40](#). The property should continue to be classified as inventory if this is consistent with entity B's strategy for this property. However, it should be transferred to investment property if there is a change in management's intention to hold the property for future rentals or for capital appreciation (for example, until market prices recover).

Determining the correct classification of such a property requires judgement. The inception of a lease with third parties, in itself, does not automatically require reclassification as investment property, although it might be indicative of a change in management's intention.

The property can, therefore, continue to be classified as inventory to the extent that it is available for immediate sale in its present condition, at a current market price, in the ordinary course of business.

Factors to consider include:

- Is the property actively marketed for sale?
- Is the property available for sale at a price that is reasonable relative to its current market value?
- Does a market exist for properties with sitting tenants, with longer lease terms, such that the property is in a condition to be sold immediately?
- Where there is no market for properties with sitting tenants, are the terms of any leases less than the length of the period that other similar properties take to be sold in the ordinary course of business under current market conditions?

If the entity is unwilling to sell the property at the current depressed market price, it is likely that the property's intended use has changed to meet the definition of an investment property – that is, held to earn rental income and for capital appreciation. Factors to consider are:

- Has the board decided to postpone the sale of the property until the market price recovers?
- Is there a change in the business plan that takes into account the rental income earned and the necessary future maintenance expenses?
- Has this change in business plan been publicly announced?

- Is the property no longer actively marketed for sale?
- Is there currently no active market for similar properties?
- Is the property available for sale only at a price that is not reasonable relative to its current market value?

4. Rental income: accounting by lessors

4.1. Overview of guidance

Owners of investment property lease out property to tenants. Guidance on lessor accounting and lease incentives is contained in IFRS 16.

4.2. Definition of a lease

Under IFRS 16, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. A contract contains a lease if fulfilment depends on an identified asset and it conveys the right to control the use of that identified asset throughout the period of use.

IFRS 16 requires a lessor to account for the lease and non-lease components of a contract separately. [IFRS 16 para 12]. The lessor should also assess whether there are separate lease components in the lease (for example, lease of property, furniture and electrical equipment). [IFRS 16 para 12 and App B paras B12, B32].

Non-lease components in a property lease contract might be the provision of building maintenance services, lift services or concierge services.

The allocation of the consideration between lease and non-lease components is performed in accordance with IFRS 15. [IFRS 16 para 17]. The lessor should allocate the transaction price to each component on the basis of relative stand-alone selling prices. This is achieved as follows:

- At contract inception, the lessor determines the stand-alone selling price of each component.
- The stand-alone selling price is the price at which an entity would sell the service separately to a customer. Paragraphs 76 to 80 of IFRS 15 provide further guidance on how to estimate the stand-alone selling price.
- The lessor allocates the consideration in proportion to the stand-alone selling prices.

The non-lease components would then need to be accounted for in accordance with the relevant standard. For example, security or cleaning services would be accounted for in accordance with IFRS 15. The lease components would be accounted for in accordance with IFRS 16.

Special consideration is required where contracts include payments related to property taxes and insurance. Where property taxes and insurance do not constitute a separate component, no consideration is allocated to them separately; consideration (including any payment received as reimbursement of property taxes or insurance) is allocated only to the identified lease and non-lease components.

As noted in section 2.2.8, investment property might be held under a lease. This raises the question of how to account for the subsequent lease of the land and/or building to tenants. There are two potential situations that could arise: a building situated on leased land might be sublet to multiple tenants, or to a single tenant.

Where different floors in a building are sublet to multiple tenants, it is necessary to determine whether there is a lease of land as a separate component of the lease arrangement with each tenant. Whether the land on which the building is situated is a separate lease component needs to be determined in light of the lease contract between the lessor and its tenants, to determine if there are any specific provisions in relation to the underlying land lease.

If the land is used by multiple tenants located on different floors of a building, there is unlikely to be a lease in place for a separate land component. This is analogous to common areas such as foyers and lifts in a building, which are not considered separate lease components, because the tenant cannot direct the use of these elements. [IFRS 16 App B para B9]. This is also similar to capacity portions of an asset where a portion of an asset that is not physically distinct is not an identified asset and, therefore, does not meet the definition of a lease. [IFRS 16 App B para B20]. Given this, the land would not be generally considered to be a lease component. The ground lease is effectively an input required by the lessor to enable leasing of the building. The lessor would classify the building lease as operating or financing, considering the indicators in paragraphs 62 to 66 and B53 and B54 of IFRS 16.

Where the land and building have been leased to one tenant only, or where there are multiple tenants in distinct sections of a single-storey building, both the land and building are identified assets being leased by the tenant. Real estate entities will need to assess the classification of the land and building elements as a finance lease or an operating lease separately. [IFRS 16 App B para B55]. Given that the land and building are held under a lease, any sublease is classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset. [IFRS 16 App B para B58(b)]. In the context of the land element, the fact that land normally has an indefinite life would be disregarded, and classification would be based on the term of the ground lease.

In order to classify each element of the lease, the lessor will need to allocate lease payments between the land and the building elements on a relative fair value basis. If it is not possible to allocate lease payments between the two elements on a reliable basis, the entire lease would be classified as a finance lease, unless it is clear that both the land and building elements are operating. [IFRS 16 App B para B56]. Real estate entities typically conclude that the building element is an operating lease which, in turn, confirms the classification of the land lease as operating.

4.2.1. Lease term

The lease term is the non-cancellable period for which the lessee has agreed to lease the asset from the lessor, together with periods covered by options to extend the lease that the lessee is reasonably certain to exercise, and periods covered by options to terminate the lease that the lessee is reasonably certain not to exercise. [IFRS 16 App A]. The non-cancellable period of a lease is any period during which the lessee is unable to terminate the contract. However, lessees of property often have the option either to extend the lease or to cancel the lease earlier than the contractual lease term. For example, a lessor and a lessee enter into a lease agreement for five years. The lessee might have the option to cancel the lease after three years at no significant penalty. The lessee might also have the option to extend the lease for an additional five years. When determining which periods covered by options are included in the lease term in order to account for the lease income in the case of an operating lease, the lessor needs to consider what the lessee might reasonably be expected to do. If the lessee can reasonably be expected to cancel the lease, the lease term would be three years. If the lessee can reasonably be expected to extend the lease, the lease term would be 10 years. If the lessee is reasonably expected to neither extend nor cancel, the lease term would be five years. An entity should consider all facts and circumstances that create an economic incentive for the lessee to exercise an extension option (or not to exercise a termination option) in order to assess whether the exercise (or the non-exercise) is reasonably certain. These could include, among other factors, contractual terms, market conditions, significant leasehold improvements undertaken or expected to be undertaken by the lessee, the importance of the underlying asset to the lessee's operations, the lessee's costs relating to the termination of the lease and any conditionality associated with the exercise of the options.

A lessor does not reassess, after the commencement date, whether or not an option is reasonably certain to be exercised by the lessee. A lessor would reassess the lease term only upon a change in the non-cancellable period of the lease or a lease modification.

4.3. Rental income: lessor accounting

The table below summarises the requirements for lessor accounting under IFRS 16. The key matter, in determining the accounting for lessors, is whether the leases entered into are classified as finance or operating leases.

4.3.1. General principles

	Finance leases	Operating leases
Classification	A lease is classified as a finance lease if substantially all the risks and rewards incidental to ownership of an underlying asset are transferred to the lessee. [IFRS 16 para 62].	A lease is classified as an operating lease if substantially all the risks and rewards incidental to ownership of an underlying asset are retained by the lessor. [IFRS 16 para 62].
Initial recognition	A receivable is recognised at an amount equal to the net investment in the lease. [IFRS 16 para 67].	The underlying asset remains recognised in the lessor's balance sheet. [IFRS 16 para 88].

Initial direct costs	Initial direct costs in negotiating and arranging the lease are included in the initial measurement of the finance lease receivable, and they reduce the amount of income recognised over the lease term. [IFRS 16 para 69].	Initial direct costs in negotiating and arranging the lease are added to the carrying amount of the leased asset, and they are subsequently recognised as an expense over the lease term. [IFRS 16 para 83].
Subsequent measurement and lease income	Finance income is recognised based on a pattern reflecting a constant periodic rate of return. [IFRS 16 para 75].	Lease income is recognised on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the leased asset is diminished. [IFRS 16 para 81].

Appendix A to IFRS 16 defines lease payments in the same way for both lessees and lessors, comprising the following components:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable by the tenant;
- variable lease payments that depend on an index or a rate;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option (if the lessee is reasonably certain to exercise that option); and
- payments of penalties for terminating the lease (if the lease term reflects the lessee exercising the option to terminate the lease).

For the lessor, lease payments also include any residual value guarantees provided to the lessor. The definition in [Appendix A to IFRS 16](#) of lease payments also specifically excludes payments allocated to non-lease components, and lessors are required to account for these components separately from lease components.

[IFRS 16 paragraph 81](#) requires a lessor to recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. If a lessor assesses some rents on an operating lease to be increasingly uncertain, IFRS 16 does not specify a collectability criterion that must be met in order for a lessor to recognise operating lease income. A lessor could therefore continue to recognise operating lease income. However, a lessor is required to apply IFRS 9's impairment requirements to lease receivables. Impairment losses on lease receivables should be recognised separately as an expense. For guidance on modifications of operating leases, refer to [section 4.12](#).

4.3.2. Rental income relating to an underlying variable: contingent rentals

Payments due under lease agreements entered into between real estate entities and tenants might be calculated based on an underlying variable. For example, rental income might be calculated as a percentage of future sales, or it might vary depending on a rate or index.

IFRS 16 distinguishes between three kinds of contingent payments, depending on the underlying variable and the probability that they actually result in payments:

1. Variable lease payments based on an index or a rate. Variable lease payments based on an index or a rate (for example, linked to a consumer price index, a benchmark interest rate or a market rental rate) are part of the lessor's lease payments and accounted for as part of the lease liability. These payments are initially measured using the index or the rate at the commencement date (instead of forward rates/indices).
2. Variable lease payments based on any other variable. Variable lease payments not based on an index or a rate are not part of the lessor's lease payments, such as payments of a specified percentage of sales made from a retail store. Such payments are recognised in profit or loss in the period in which the event or condition that triggers those payments occurs.
3. In-substance fixed payments. Lease payments that, in form, contain variability but, in substance, are fixed are included in the lessor's lease payments. The standard states that a lease payment is in-substance fixed if there is no genuine variability.

For lessees, in relation to payments initially excluded from the lease liability, if the variability is resolved at a later point in time so that the payments become fixed for the remainder of the lease term (for example, insurance premiums or taxes that become known and unavoidable for the upcoming year), they may become in-substance fixed payments at that point in time in accordance with [paragraph B42 of IFRS 16](#).

However, there is no similar explicit requirement in IFRS 16 for a lessor under an operating lease. Lessors could apply the guidance as for lessees or, alternatively, they could recognise the variable lease payments in the periods in which they occur. The method applied is an accounting policy choice, and it should be applied consistently in accordance with IAS 8.

IAS 8 requires that, in the absence of specific guidance, users should consider whether other IFRSs deal with similar issues. Lessee accounting requires contingent rent to be recognised as the event or condition that triggers those payments occurs. In our view, it would be appropriate for lessor accounting for contingent rent to mirror that of lessee accounting.

Example – Variable lease payment based on an index or a rate					
<p>Reference to standard: IFRS 16 para 81, IFRS 16 para 42(b) Reference to standing text: 15.134, 15.77, EX 15.134.5 Industry: Real Estate</p>					
<p>Background A lessor agrees an operating lease of office space with a lessee on the following terms:</p> <ul style="list-style-type: none"> • Lease term: 10-year non-cancellable term. • Annual payment: C100,000 in the first year, with a CPI increase in every following year. • Market rent review: beginning of year 6, with a CPI increase in every following year. • At the start of year 2, CPI has increased by 2% so the lease payment for year 2 will be CU102,000. <p>In year 1, the lessor initially measures lease income as C100,000.</p>					
<p>Question How should the lessor determine the lease income to be recognised in year 2?</p>					
<p>Answer Paragraph 81 of IFRS 16 requires lessors to recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. When determining in year 2 the (revised) lease payments for years 6–10, we believe that the lessor has an accounting policy choice between the following two approaches:</p> <ol style="list-style-type: none"> 1. not revising the lease payments for years 6–10; or 2. revising the lease payments for years 6–10. <p>This accounting policy choice is similar to the one available for the lessee which is further explained and illustrated in EX 15.77.3. However, there is no explicit requirement in IFRS 16 for a lessor to remeasure the lease payments in the same way as a lessee measures the lease liability.</p>					
<p>Approach 1 The rental income recognised by the lessor in year 2 would be C100,888 (being total lease payments of C908,000/9 years), reflecting recognition of income without revising the lease payments for years 6–10 on a straight-line basis, in line with paragraph 81 of IFRS 16.</p>					
Year	2	3	4	5	6–10 (annual)
Lease payments (C)	102,000	102,000	102,000	102,000	100,000
<p>Approach 2 The rental income recognised by the lessor in year 2 would be C102,000 (being total lease payments of C918,000/9 years), reflecting recognition of income based on the revised lease payments for years 6–10 on a straight-line basis, in line with paragraph 81 of IFRS 16.</p>					
Year	2	3	4	5	6–10 (annual)
Lease payments (C)	102,000	102,000	102,000	102,000	102,000
<p>The policy chosen should be consistently applied and disclosed. If this choice represents a critical accounting judgement, the entity should consider the IAS 1 disclosure requirements. See chapter 4 para 152 for further details.</p>					

Example – Rent reviews

Background

Entity V, a tenant, has entered into a lease with entity Q. The terms of the lease are as follows:

- The rent for the year ended 31 December 20X1 is C10,000, payable on a monthly basis.
- By 28 February 20X2, entity Q has the right to review the rent charged for the year ended 31 December 20X1 and compare it to market prices for the period. Accordingly, entity Q could request a catch-up payment from entity V, to compensate for any lost income. The catch-up payment needs to be agreed by both parties.
- The determination of the catch-up payment was completed by 31 January 20X2, and the amount was determined to be C500. The payment was agreed with entity V on 15 February 20X2 and paid on the same date.
- When should entity Q recognise the catch-up rent payment?

Solution

The payment should be recognised when incurred (that is, when the lessor has the contractual right to receive payment). On 31 December and 31 January, entity Q does not have the right to receive payment. The right to receive payment is established on 15 February 20X2, and the rent review catch-up payment is recognised on that date.

4.4. Impairment of trade and lease receivables: scope exception for applying the simplified approach

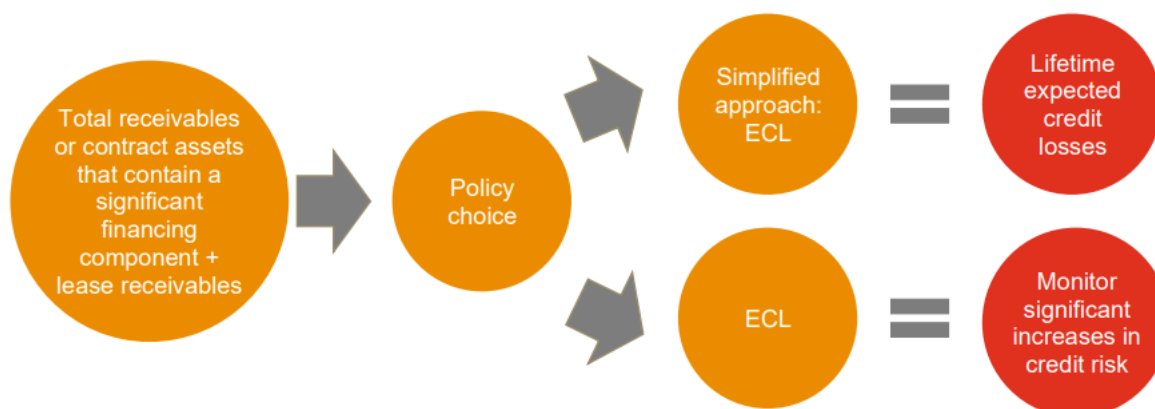
4.4.1. Expected Credit Loss ('ECL') Impairment Model

Lessors will need to determine whether lease balances are lease receivables (that is, net investments in finance leases and operating lease receivables) that are within the scope of IFRS 9's expected credit loss (ECL) model, or whether lease balances are accrued lease payments, such as those that arise from accounting for lease incentives under IFRS 16, that are within the scope of IAS 36's impairment model. Accrued lease payments are not in scope of IFRS 9 impairment guidance and are within the scope of IAS 36's impairment model. Further guidance on the principles of impairment under IAS 36 can be found in the [PwC Manual of Accounting chapter 24 paragraph 6](#).

For those lease receivables that are within the scope of IFRS 9, the standard contains a forward looking ECL impairment model. The general impairment model includes some operational simplifications for trade receivables, contract assets and lease receivables, because they are often held by entities that do not have sophisticated credit risk management systems.

These simplifications eliminate the need to calculate 12-month ECL and to assess when a significant increase in credit risk has occurred.

For trade receivables or contract assets that do not contain a significant financing component, the loss allowance should be measured at initial recognition and throughout the life of the receivable, at an amount equal to lifetime ECL. As a practical expedient, a provision matrix could be used to estimate ECL for these financial instruments. For trade receivables or contract assets that contain a significant financing component (in accordance with IFRS 15) and lease receivables, an entity has an accounting policy choice: either it can apply the simplified approach (that is, to measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout its life), or it can apply the general model. An entity can apply the policy election for trade receivables, contract assets and lease receivables independently of each other, but it must apply the policy choice consistently.



What does this mean for the real estate industry?

Short-term trade and lease receivables	A trade receivable with a maturity of less than one year will most likely qualify for the simplified model, since generally it will not contain a significant financing component. For lease receivables, entities can choose to either apply the simplified approach or the three-stage model. Under the simplified approach, the entity will recognise lifetime ECL throughout the life of the receivable. Materially higher provisions might not arise for short-term trade receivables with customers with good collection history.
Long-term trade receivables and inter-company	For trade receivables that contain a significant financing component (for example, long-term receivables), the entity will have an accounting policy option. Inter-company loans would normally not qualify for the scope exclusion and the full three-stage model would need to be applied.
Financial investments in bonds	For long-term investments such as bonds, the entity will need to apply the full three-stage model.

FAQ – What are the expected credit loss requirements for an operating lease receivable?

Reference to standard: IFRS 9, 5.5.1, 5.5.18, B5.5.44, IAS 36 para 2

Reference to standing text: 15.134, 45.54, 45.55, FAQ 45.54.2

Question 1

What type of lease balances are subject to IFRS 9's expected credit loss requirements?

Answer

Lessors will need to determine whether lease balances are lease receivables (that is, net investments in finance leases and operating lease receivables) that are within the scope of IFRS 9's expected credit loss (ECL) model, or whether lease balances are accrued lease payments, such as those that arise from accounting for lease incentives under IFRS 16, that are within the scope of IAS 36's impairment model.

See [FAQ 15.134.2](#) for further discussion of the accounting for lease incentives.

Question 2

If a lessor expects a lessee to pay all operating lease receivables in full but later than the contractual due date, does this give rise to an expected credit loss (ECL)?

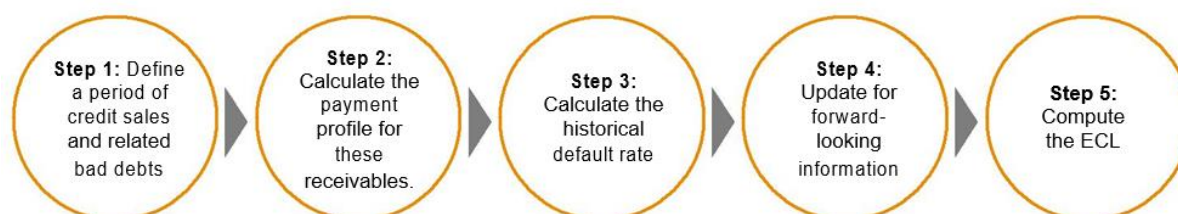
Answer

It depends. Where contractual payments are expected to be received in full but later than contractually due, in isolation this might not give rise to an ECL provision on the operating lease receivables; this is because operating lease receivables are recognised on an undiscounted basis, and so the effective interest rate can be considered to be 0%.

However, more broadly, regardless of the specific considerations regarding time value of money arising from the expected payment delay, paragraph 5.5.18 of IFRS 9 requires an entity to always consider the risk or probability that a credit loss occurs.

4.4.1.1. Provision matrix

IFRS 9 allows an operational simplification whereby entities can use a provision matrix to determine their ECL under the impairment model. A provision matrix method uses past and forward information to estimate the probability of default of lease and trade receivables.



Step 1

The first step, when using a provision matrix, is to define an appropriate period of time to analyse the proportion of lease and trade receivables written off as bad debts. This period should be sufficient to provide useful information: too short might result in information that is not meaningful, while too long might mean that changes in market conditions or the tenant base make the analysis no longer valid. In the example below, a period of one year has been selected, with a focus on lease receivables. The overall lease receivables were C10,000 and the receivables ultimately written off were C300 in that period.

Total lease income	C10,000
Bad debts written off out of this lease income	C300

Step 2

In step 2, the amount of receivables outstanding at the end of each time bucket is determined, up until the point at which the bad debt is written off. The ageing profile calculated in this step is critical for the next step, when calculating default rate percentages.

Total lease income(C)	10,000	Total paid	Ageing profile of lease income (step 3)
Paid in 30 days	(2,000)	(2,000)	8,000
Paid between 30 and 60 days	(3,500)	(5,500)	4,500
Paid between 60 and 90 days	(3,000)	(8,500)	1,500
Paid after 90 days	(1,200)	(9,700)	300 (written off)

Step 3

In this step, the entity calculates the historical default rate percentage. The default rate for each bucket is the quotient of the defaulted receivables at each bucket over the outstanding lease income for that period. For example, in the above information, C300 out of the C10,000 lease income for the period was written off.

Current lease income: historical rate of default

Since all of the receivables relating to the lease income for the period and those written off were current at some stage, it can be derived that, for all current amounts, the entity might incur an eventual loss of C300. The default rate would therefore be 3% (C300/C10,000) for all current amounts.

Lease income outstanding after 30 days

An amount of C8,000 was not paid within 30 days. An eventual loss of C300 was a result of these outstanding receivables. Therefore, the default rate for amounts outstanding after 30 days would be 3.75%.

Remaining buckets

The same calculation is then performed for 60 days and after 90 days. Although the amount outstanding reduces for each subsequent period, the eventual loss of C300 was, at some stage, part of the population within each of the time buckets, and so it is applied consistently in the calculation of each of the time bucket default rates.

The historical default rates are determined as follows:

	Current lease income	Lease payments outstanding after 30 days	Lease payments outstanding after 60 days	Lease payments outstanding after 90 days
Ageing profile of lease income (1)	10,000	8,000	4,500	1,500
Loss (2)	300	300	300	300
Default rate: (2)/(1) (%)	3	3.75	6.67	20

Step 4

IFRS 9 is an ECL model, so consideration should also be given to forward-looking information. Such forward-looking information would include:

- changes in economic, regulatory, technology and environmental factors (such as industry outlook, GDP, employment and politics);
- external market indicators; and
- tenant base.

For example, the entity concludes that the defaulted receivables should be adjusted by C100 to C400 as a result of increased retail entity failures, given that its tenant base is primarily retail focused. The entity also concludes that the payment profile and amount of lease income are the same. Each entity should make its own assumption of forward-looking information. The provision matrix should be updated accordingly.

The default rates are then recalculated for the various time buckets, based on the expected future losses.

	Current lease income	Lease payments outstanding after 30 days	Lease payments outstanding after 60 days	Lease payments outstanding after 90 days
Ageing profile of lease income (1)	10,000	8,000	4,500	1,500
Loss (2)	400	400	400	400
Default rate: (2)/(1) (%)	4	5	8.9	27

Step 5

Finally, take the default rates from step 4 and apply them to the actual receivables, at the period end, for each of the time buckets. There is a credit loss of C12 in the example illustrated.

	Total	Current lease income	Lease payments outstanding after 30 days	Lease payments outstanding after 60 days	Lease payments outstanding after 90 days
Lease receivable balances at year end: (1)	140	50	40	30	20
Default rate: (2) (%)	-	4	5	8.9	27
Expected credit loss: (1) x (2)	C12	C2	C2	C3	C5

4.4.2. Lease prepayments and cash collateral

Lease accounting might give rise to prepayments as a result of the straight-line recognition of rental income (for example, lease contracts that contain fixed escalation clauses).

- The entity should classify the prepayment as current if it expects to realise, sell or consume the prepayment during its normal operating cycle or within 12 months after the reporting period. Otherwise, the prepayment should be classified as non-current. Refer to [section 4.10](#) for further guidance on tenant deposits received.

4.4.2.1. Overview

Lessors often give incentives to tenants to occupy property. Examples of incentives include rent-free periods and discounts during the initial periods of the lease. All incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net consideration agreed for the use of the leased asset.

The lessor should recognise the aggregate cost of incentives as a reduction of rental income over the lease term. This should occur on a straight-line basis, unless another systematic basis is more representative of the time pattern over which the benefit of the leased asset is diminished. [\[IFRS 16 para 81\]](#). In practice, the use of an allocation basis other than straight-line is rare.

All incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net consideration agreed for the use of the leased asset, irrespective of the incentive's nature or form, or the timing of payments. [\[IFRS 16 para 81\]](#).

Lease incentives could take the form of reimbursements of a tenant's cost of leasehold improvements. As part of negotiating a new or renewed lease, a lessor might agree to pay to the tenant an allowance for leasehold improvements, either through an upfront payment or by requiring a tenant to submit invoices to support expenditures on leasehold improvements. The lessor will need to determine when it has an obligation under the lease contract to pay the tenant for the allowance, because this will determine the recognition point for both the inclusion of the lease incentive in the reduction of rental income under IFRS 16 and accrual for the reimbursement of these costs to the tenant.

Except in circumstances where the lessor has substantive discretion to accept or reject future claims under the allowance, the past transaction that obligates the lessor is the commencement of the lease arrangements, rather than the submission of the claim for reimbursement by the tenant or payment of the allowance. The lessor has promised to reimburse the tenant for certain items as part of the net consideration agreed for the use of the leased asset, and that use starts on the commencement date of the lease. Whether or not the tenant submits claims for reimbursement is outside the control of the lessor, and it would usually be considered probable that the tenant would claim all, or a substantial portion, of the reimbursement rights. The expected amount of reimbursement should be accrued on the commencement date of the lease and included as a reduction of rental revenue over the lease term.

Example – How should lease incentives be accounted for?

Reference to standard: IFRS 16 para 81
Reference to standing text: 15.134, EX 15.134.2

Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee, as incentives for the agreement of new or renewed operating leases are included in the lease payments (as defined in IFRS 16 appendix A). They are not considered to be part of the initial costs that are added to the carrying amount of a leased asset. Instead, they are deducted from the lease payments, and allocated together with them, on either a straight-line basis or another systematic basis.

Example 1 – Operating lease incentive: rent-free period

Under a 10-year lease agreement, the lessor gives a one-year, rent-free period followed by a fixed rent of C1.1m per annum for nine years. This is equivalent to 10 years' rent of C0.99m per annum. The cost of the incentive should be spread over the lease term. Therefore, C0.99m of rental income will be recognised each year in the income statement. At the end of the first year, the lessor will recognise accrued lease payments of C0.99m, which will be reduced by C0.11m each year for the next nine years.

Example 2 – Operating lease incentive: lessor contribution to lessee fit-out costs

Alternatively, the lessor agrees with the lessee to make an upfront cash payment of C1m to contribute towards the lessee's own fit-out costs, with a fixed annual rental of C1.1m per annum for the 10-year lease. This is also equivalent to an annual rent of C1m per annum without the incentive. Therefore, C1m will be recognised as rental income each year of the lease. The C1m incentive will initially be recognised as an asset for accrued lease payments, which will be amortised by C0.1m each year to the income statement.

Accrued lease payments are not in scope of IFRS 9 impairment guidance and are within the scope of IAS 36's impairment model. See [chapter 24 paragraph 6](#) for further details on the basic principles of impairment under IAS 36.

4.4.2.2. Loans issued to tenants at off-market terms as a rent incentive

Example – Loans issued to tenants at off-market terms as a rent incentive

Reference to standard: IFRS 16 para 81 and App B para B2
Reference to standing text: 15.134, EX 15.134.6
Industry: Real Estate

Background

Entity A entered into a five-year operating lease agreement over office property with tenant B. To persuade tenant B to rent the property, entity A issued a low-interest rate loan (5%) of C100,000 to tenant B as an incentive. The term of the loan is equal to the term of the lease (that is, five years), with equal annual payments of interest of C5,000, and the principal will be repaid at the end of the five years. The market interest rate is 10%. Entity A has assessed the loan contract to be a separate unit of account from the rights and obligations under the lease, and it is accounting for the loan under IFRS 9. [IFRS 16 App B para B2]. The fair value of the loan on initial recognition is C81,050, which is the fair value for a loan with a market interest rate of 10%.

Question

How should entity A account for the difference between the market interest rate and the interest rate on the issued loan?

Answer

The cost of incentives given in acquiring a lease should be recognised as a reduction of rental income over the lease term. [IFRS 16 para 81]. In this case, the cost of the incentive is C18,950, which is the off-market element of the loan.

This cost should be amortised over the lease term on a straight-line basis.

This incentive cost should be amortised over the lease term on a straight-line basis.

[Note that numerical entries are rounded for simplicity.]

Initial recognition (issue of the loan):		
	Dr (C)	Cr (C)
Loan recognised on the balance sheet (BS) – fair value of the loan	81,050	-
Lease incentive (BS)	18,950	-
Cash	-	100,00
Subsequent measurement: loan at amortised cost (using the effective interest method)		
The loan will be measured at amortised cost using the effective interest method. The journal entries for year 1 will be as follows:		
	Dr (C)	Cr (C)
Loan (BS) (C8,105 – C5,000)	3,105	-
Cash (BS) – payment of annual interest	5,000	-
Interest income (P&L) – (Carrying amount × Interest rate = 81,050 × 10%)	-	8,105
Amortisation of lease incentive (on a straight-line basis)		
	Dr (C)	Cr (C)
Rental income (P&L) – (C18,950 / 5 years)	3,790	-
Lease incentive (BS)	-	3,790

4.4.2.3. Accounting for assets arising from operating lease incentives

Assets arising from operating lease incentives are not in scope of IFRS 9 as financial assets, except to the extent that the recovery of any incentive is included in operating lease receivables recognized. However, where these assets are denominated in a foreign currency, they are considered monetary assets for the purposes of applying IAS 21, as they will be received in a fixed number of units of currency as specified in the lease contract.

Example – Rent incentives in foreign currency		
Background		
Entity A entered into a 10-year operating lease with entity B on 1 January 20X1. To persuade entity A to sign the lease, entity B has granted to entity A an initial rent-free period of two years. The rent for the remaining eight years is C750 per year. Entity B's functional currency is CAU. The C:CAU exchange rates are as follows:		
Throughout 20X1 and as at 31 December 20X1		1:2
Throughout 20X2 and as at 31 December 20X2		1:3
How should entity B recognise rental income for 20X1 and 20X2?		
Solution		
Entity B should recognise rent incentives on a straight-line basis as follows:		
Entries for the year ended - 31 December 20X1		
	C	CAU
Rent income (C750 × 8/10)	(600)	(1,200) (C600 × 2)
Rent incentive asset	600	1,200 (C600 × 2)

Entries for the year ended - 31 December 20X2		
	C	CAU
Rent income (C750 * 8/10)	(600)	(1,800) (C600 * 3)
Rent incentive asset	600	1,800 (C600 * 3)
Rent incentive asset: revaluation of balance Difference between (C600+C600) * 3 = CAU3,600 and CAU1,200 + CAU1,800 = CAU3,000)		600
Foreign exchange gain on revaluation of rent incentive asset		(600)

4.5. Premiums for properties in a prime location

Real estate entities might receive initial premiums from tenants over and above annual rents, in order for a tenant to gain access to property in a prime location. In such cases, all incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net consideration agreed for the use of the leased asset, irrespective of the incentive's nature or the form or timing of payments. [IFRS 16 para 81]. Similar to other lease incentives, real estate entities should recognise the aggregate amount of premiums received in rental income over the lease term.

Example – Initial premium

Background

Entity A has developed a state-of-the-art shopping, entertainment and dining complex, which is the only one in its region.

Tenant B has entered into a 10-year lease with entity A. The tenant has agreed to pay an initial premium of C2 million in addition to the annual rental of C1 million.

Can entity A recognise the entire initial premium received in the first year of the lease?

Solution

No, entity A should recognise the premium received on a straight-line basis over the lease term. This would result in lease income of C1.2 million per annum $((C1 \text{ million} \times 10 \text{ years}) + C2 \text{ million})/10$.

4.6. Surrender premiums

Payments between the lessor and the former lessee, also known as 'surrender premiums', are common in the real estate industry where, for example, the lessor needs to provide an incentive to existing tenants to vacate the property in order to redevelop it. Depending on the specific facts and circumstances, such costs might need to be expensed or capitalised by the lessor. The following table addresses two scenarios that are common in the real estate industry:

Surrender premium paid to remove existing tenants to allow ...	
... redevelopment of a recently acquired or existing investment property	<p>Redevelopment costs are costs incurred subsequent to the acquisition of the investment property, to add to or replace part of it.</p> <p>An entity should determine whether subsequent expenditure is capitalised, using a test similar to the test used for owner-occupied property in IAS 16. [IAS 40 para BC B40].</p> <p>Since no redevelopment is possible in the presence of the existing tenant, the surrender premium paid to incentivise the tenant to move out is a cost of bringing the investment property to the condition necessary for it to be capable of operating in the manner intended by management. [IAS 40 para BC B41; IAS 16 para 16(b)].</p>

	<p>The surrender premium is therefore capitalised as part of the investment property. This applies to entities using both the cost model and the fair value model for investment properties. See ‘Example – Surrender premiums paid to remove existing tenants to allow redevelopment of a real estate property’ below.</p>
<p>... new tenants to occupy recently acquired or existing investment property</p>	<p>Capitalisation of costs on the carrying amount of an item of property ceases when the item is in the condition necessary for it to be capable of operating in the manner intended by management. The investment property is already in use as intended by management (no redevelopment is necessary), and so the incurred costs cannot be capitalised.</p> <p>In addition, IFRS 16 requires initial direct costs incurred by lessors in negotiating an operating lease to be added to the carrying amount of the leased asset and expensed over the lease term. Based on this principle, the surrender premium should be expensed, because it is not a cost of entering into the (new) operating lease.</p> <p>If the surrender premium is payable as a result of a modification of the lease contract, the payment should be accounted for from the effective date of the modification (see further section 4.12). This applies to entities using both the cost model and the fair value model for investment properties.</p> <p>If the surrender premium is payable as a result of an existing break clause term contained in the lease contract, this would result in a change in the lease term. In addition, the lessor previously should not have included the surrender premium payment within lease payments unless it was reasonably certain to be exercised but, given exercise of the break clause, the premium would now form part of lease payments to be recognised.</p> <p>In accordance with paragraph 81 of IFRS 16, lease payments from operating leases should be recognised as income on premium payable from an existing break clause either a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished. There are therefore two possible approaches for the recognition of the surrender premium payable from an existing break clause based on the guidance in paragraph 81.</p> <p>One approach would be to recognise the surrender premium prospectively on a straight-line basis over the new lease term. Although not a modification, since the surrender premium and break clause were already included in the original lease contract, this straight-line approach is consistent with modification guidance in paragraph 87 of IFRS 16 (see further section 4.12).</p> <p>Another approach would be to calculate the overall lease payments (including the surrender premium) that would have been recognised if the reduced lease term had been determined at the commencement date. Any difference between the lease payments recognised prior to notification of the exercise of the break clause and the revised lease payments calculated assuming the new, shorter lease term would be recognised as a cumulative catch-up adjustment. The lessor would then recognise the remaining revised lease payments over the remaining lease term. Because the lease term has now been reduced, the overall benefit from the use of the leased asset has been accelerated, and so applying a catch-up adjustment reflects the revised pattern of benefit from the lessee’s use of the asset.</p> <p>In our view, either approach could be followed, and an entity therefore has an accounting policy choice. The policy chosen should be consistently applied and disclosed where material. See ‘Example – Termination premiums paid to remove existing tenants to allow new tenants to occupy the real estate property’ and ‘Example – Termination premiums paid on exercise of an existing break clause within the lease contract’ below.</p>

Example – Surrender premiums paid to remove existing tenants to allow redevelopment of a real estate property

Background

Entity A obtained all of the necessary authorisations to significantly redevelop an existing investment property for continued future use as an investment property. The redevelopment is only possible if the property is vacant. After redevelopment, the previously assessed standard of performance of the property will be enhanced, with significantly more rentable space. Entity A negotiates a termination premium to remove the existing tenants, to enable it to perform the redevelopment. The entity has chosen to apply the cost model to its investment properties.

Does the termination premium paid to the existing tenants represent an integral part of the costs of redeveloping the property in accordance with [paragraph 17 of IAS 40](#)?

Solution

The termination premiums are costs that are directly attributable to the redevelopment, and they should be capitalised as part of the investment property. [\[IAS 16 para 16\(b\)\]](#). The termination premium paid to incentivise the tenants to move out is a cost of bringing the investment property to the condition necessary for it to be capable of operating in the manner intended by management. [\[IAS 40 para BC B41\]](#).

Example – Termination premiums paid to remove existing tenants to allow new tenants to occupy the real estate property

Background

Entity A pays termination premiums to remove the existing tenants, to allow it to rent out the property to new tenants on lease contracts with more favourable terms and conditions. The entity has chosen to apply the cost model to its investment properties.

Does a termination premium paid to existing tenants represent an integral part of the costs of the property in accordance with [paragraph 17 of IAS 40](#)?

Solution

No. The investment property is already in use as intended by management, and so the incurred costs cannot be capitalised. [\[IAS 40 para BC B41\]](#). The termination premium is recognised as part of rental income, because it is not a cost of entering into the (new) operating lease. If the surrender premium is payable as a result of a modification of the lease contract, the payment is accounted for from the effective date of the modification (see further [section 4.12](#)).

If the surrender premium is payable as a result of an existing term contained in the lease contract, entity A could apply the guidance in [paragraph 81 of IFRS 16](#), either by accounting for the premium as if it was the result of a modification, or by recognising a cumulative catch-up adjustment. The approach selected is an accounting policy choice that should be consistently applied and disclosed where material. Both approaches are illustrated further in the example below.

Example – Termination premiums paid on exercise of an existing break clause within the lease contract

Background

Entity A enters into a lease contract with a tenant where the lease term is 10 years. The lease contract contains a break clause at year 5 which, if exercised, would require payment of a surrender premium. At commencement of the lease, entity A considered that the break clause was reasonably certain not to be exercised and, as such, determined that the lease term was 10 years. At the end of year 3, due to unforeseen circumstances, the tenant has formally communicated that it will exercise the break clause in year 5.

In line with [paragraph 21 of IFRS 16](#), this would result in a change in the lease term. In addition, the lessor previously did not include a surrender premium payment within lease payments but, given exercise of the break clause, the premium would now form part of lease payments to be recognised.

How should the lessor account for the surrender premium, now that the break clause has been exercised and the lease term shortened?

Solution

Although not a modification, since the surrender premium and break clause were already included in the original lease contract, there are two possible approaches for the recognition of the surrender premium based

on the guidance in [paragraph 81 of IFRS 16](#). Entity A could account for the payment as if it was the result of a lease modification (see further [section 4.12](#)), which would result in the surrender premium balance being recognised prospectively over the new revised lease term of two years, along with the remaining lease payments receivable.

Alternatively, a cumulative catch-up adjustment could be recognised. Under this approach, entity A would calculate the overall lease payments (including the surrender premium) that would have been recognised if the lease term had been determined to be five years at the commencement date. Any difference between the lease payments recognised prior to notification of the future exercise of the break clause and the revised lease payments calculated assuming the new, shorter lease term would be recognised as a cumulative catch-up adjustment. Entity A would then recognise the remaining revised lease payments over the remaining lease term.

The approach that entity A selects is an accounting policy choice that should be consistently applied and disclosed where material.

4.7. Assumption of potential tenant's existing lease

Real estate entities might enter into agreements with prospective tenants, to assume the tenant's existing lease with a third party, in order to incentivise the tenant to enter into a new lease agreement for their own property.

For example, entities A and B own properties A and B respectively. Entity B has a lease agreement with tenant C over property B. Entity A might undertake to pay any remaining lease payments of tenant C under that lease, in exchange for tenant C entering into a new lease agreement for property A. In accordance with lessee accounting under IFRS 16, entity A must recognise a right-of-use asset and a corresponding liability at the commencement date of assuming tenant C's lease. [\[IFRS 16 para 22\]](#).

4.8. Key money

An entity looking to move to a sought-after location might make payments to the lessor in order to take over the lease. Such payments are often referred to as 'key money'. From the lessor's perspective, such payments are considered as part of the lease income and would be recognised over the term of the lease.

Example – Key money

Background

Entity B entered into a five-year operating lease with entity A for a store in a prime location. Entity A has paid an amount of C500 to entity B to obtain the lease.

How should entity B account for the amounts received?

Solution

Entity B should recognise the payment as part of the lease income to be received under the lease agreement. The key money payment would be recognised as deferred rental income on the balance sheet, and it would be amortised over the lease term of five years, resulting in additional rent of C100 per year (C500 over five years).

4.9. Letting fees

Initial direct costs are often incurred by lessors in negotiating and arranging a lease. They are defined as '*Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained ...*'. [\[IFRS 16 App A\]](#).

Under this definition, only incremental costs can be treated as initial direct costs. Internal costs that are not incremental – such as administration, selling expenses and general overheads – should be recognised as an expense as incurred. Incremental external costs, in the form of agent commissions and legal, arrangement and professional fees, normally qualify as initial direct costs.

Initial direct costs incurred by lessors in obtaining an operating lease are added to the carrying amount of the leased asset, and they are recognised as an expense over the lease term on the same basis as the lease income. [\[IFRS 16 para 83\]](#). It is important to amortise initial direct costs separately from the asset, because they will be recognised as an expense over the lease term rather than over the life of the asset. The lease term is likely to be a significantly shorter period than the life of the asset. Recognition of initial direct costs as an immediate expense is not acceptable.

If an entity measures investment property at fair value, it should carefully assess all effects of letting fees incurred on the calculated fair value, so that no double counting occurs. Valuers might consider the impact of letting fees when determining the fair value of the property. If letting fees are included, the entity will not need to add the impact of letting fees. By contrast, if the valuation excludes the impact of letting fees, the entity will need to add the letting fees when determining the fair value, to ensure that it compares like with like. [IAS 40 para 50(d)]. This is illustrated in the example below.

Example – Letting fees incurred, fair value model		
Background		
Entity A leases out investment property under an operating lease, and it pays letting fees to an agent for attracting new tenants. The agent receives a commission for this service when the tenant enters into a contract to rent the property. The letting fees paid to the agent are directly attributable to the lease agreement with that specific tenant. The lease term is three years.		
Entity A initially measures its investment property on acquisition at cost (including transaction costs), and it adopts a policy of fair value for subsequent measurement in accordance with IAS 40.		
The acquisition cost of the property is C158. The fair value of the property as at the year end is C159.70.		
Should entity A capitalise letting fees under the fair value model?		
Solution		
Yes. The letting fees incurred should be added to the carrying amount of the investment property and recognised on a straight-line basis over the lease term. Given that entity A applies the fair value model, the effect of capitalisation of letting fees on subsequent measurement of the property is illustrated below:		
	C	Description
Acquisition cost	158	
Capitalised letting fees	3	Fair value of the property immediately after letting = C161
Amortisation of capitalised letting fees	(1)	Amortisation over 3 years
Fair value gains/(losses)	(0.30)	The fair value gain/(loss) illustrated is effectively the residual movement in the property's value over the year, after taking into account the effect of capitalising and amortising letting fees (159.70 – 158 – 3 + 1 = –0.30)
Carrying value at 31/12/X1	159.70	Fair value of property at year end, according to the valuation report = 159.70

4.10. Tenant deposits received

The terms of a property lease contract typically require the lessee to provide a security deposit to the lessor. The security deposit is held by the lessor throughout the term of the lease and carries no, or a low rate of, interest. The deposit is refunded to the lessee at the end of the lease term if the lessee has fully performed and observed all of the conditions set out in the lease contract. If the lessee has not abided by the relevant conditions, the lease terms generally permit the lessor to apply the security deposit to remedy the breach and to indemnify the lessor from any consequential costs and losses incurred.

The amount of the deposit to be paid is usually determined during the negotiations between landlord and prospective tenant regarding the terms of the lease and the rental payments. In some jurisdictions, for example, it is not unusual for a landlord to accept a lower rental if the tenant is willing to provide a large security deposit.

Tenant deposits will generally meet the definition of cash for the lessor if they are held in a bank account belonging to , and accessible on demand to, the lessor. Restrictions on the use of amounts held as a deposit arising from a contract with a third party lessee do not result in the deposit no longer being cash, unless those restrictions change the nature of the deposit in a way that it would no longer meet the definition of cash in IAS 7. This was clarified in an IFRS Interpretations Committee Agenda Decision in April 2022.

Often tenant deposits qualify as financial instruments where the contract gives rise to a financial asset of one entity (the lessee) and a financial liability of another entity (the lessor). [IAS 32 para 11].

However, an alternative view to the above is that security deposits paid by a lessee could be considered to be within the scope of IFRS 16. IFRS 9 excludes rights and obligations under leases to which IFRS 16 applies. In light of the interdependency of the amounts of deposit and monthly rental, the deposit – and its refund at the end of the lease term – could be viewed as lease payments.

Consistent with other lease incentives, the amount received from the tenant, and the amount to be repaid to the tenant at the end of the lease, would be included in the total lease payments to be recognised on a straight-line basis over the lease term.

Example – Accounting for tenant deposits

Reference to standard: IFRS 9 para 3.2.3, 5.1.1, 5.3.1, 4.2.1, IFRS 16 para 81, IAS 32 para 11, 43

Reference to standing text: 15.134, FAQ 15.134.7

Industry: Real Estate

Background

Entity A has received a security deposit from tenant X of C500,000. Entity A is required to pay interest of 2% to tenant X on the deposit received. Tenant X could receive interest of 5% from a similar type of instrument with similar credit risk in the market. (The determination of the market interest rate considers whether there are any security or collateral arrangements specified in the agreement, or if tenant X is exposed to unsecured credit risk of entity A.) The deposit is repayable at the end of the five-year lease agreement. The lessor can apply the security deposit to remedy any breach in contractual conditions and to indemnify the lessor from any consequential costs and losses incurred, or the deposit can be used to settle lease receivables outstanding at the end of the lease. The lease is classified as an operating lease by entity A.

Question

How does entity A account for the refundable tenant deposit received?

Answer

An entity will have to determine whether the security deposit paid by a lessee is accounted for under IFRS 9 as a separate unit of account from the rights and obligations under the lease, or whether it is within the scope of IFRS 16 (for example, as a prepaid lease payment). For lessors, IFRS 9 excludes rights and obligations under operating leases to which IFRS 16 applies, except for the impairment and derecognition of operating lease receivables, and embedded derivatives within leases.

Accounting under IFRS 9

Tenant deposits qualify as financial instruments where the contract gives rise to a financial asset of one entity (tenant X) and a financial liability of another entity (entity A) [IAS 32 para 11], where this instrument is considered to be separate from the lease rights and obligations. [IFRS 9 para 2.1(b)]. Under IFRS 9, entity A's liability is initially recognised and measured at fair value, and then subsequently at amortised cost using the effective interest method. [IFRS 9 paras 5.1.1, 5.3.1, 4.2.1]. The fair value is calculated as the present value of the future cash flows, using the market interest rate of 5%, being the interest rate that would be received from a similar type of instrument in the market. The fair value of the C500,000 deposit is C435,058.

The difference between the nominal value and the fair value of the liability of C64,942, at initial recognition, would be treated as an initial lease payment and recognised on a straight-line basis over the lease term of five years.

Accounting under IFRS 16

Tenant deposits qualify as part of the rights and obligations under the lease when they are considered to represent an integral part of the lease contract rather than a separate unit of account that would be within the scope of IFRS 9.

Consistent with other payments made, the amount received from the tenant, less the amounts to be repaid to the tenant over the lease term and at the end of the lease, would be included in the total lease payments to be recognised on a straight-line basis over the lease term.

Regardless of the approach taken in accounting for the tenant deposit, the receipt of the deposit might affect accounting for any operating lease receivables recognised under the lease. For example, it could be taken in account when measuring expected credit losses under the impairment model, and in determining whether the cash collateral received under the deposit arrangements results in derecognition of any operating lease receivable balances in accordance with paragraph 3.2.3 of IFRS 9. However, in most cases, it is unlikely that the receipt of cash collateral in the form of a security deposit would result in settlement of operating lease receivables and hence in their derecognition under paragraph 3.2.3 of IFRS 9.

4.11. Tenant obligations to restore a property's condition

Lease agreements might include a clause requiring tenants, at the conclusion of the lease, to restore the property's condition to the same level as existed at commencement of the lease. In such cases, a tenant might make monthly payments to the lessor in respect of bringing the building to its original pre-lease condition on the tenant's behalf. These monthly payments should be recognised as revenue by the lessor on a straight-line basis over the lease term.

Example – Reimbursement of recondition expenses

Background

Entity T receives a monthly payment from tenant V for tenant V's contractual obligation to bring the building to its original (pre-lease) condition. This payment is included in the monthly lease payment from tenant V.

Entity T is planning to refurbish the property after the end of tenant V's lease.

How should entity T account for any payments received from tenant V for bringing the property to its pre-lease condition?

Solution

Tenant V has agreed to pay a higher lease payment each period in lieu of having to restore the building to its pre-lease condition at the end of the lease. As such, the monthly payments should be recognised on a straight-line basis over the lease term.

The fact that entity T is planning to refurbish the property prior to leasing it again does not impact the timing of recognition of lease income, because it does not represent an obligation that entity T must perform under the lease contract with tenant V.

4.12. Lease modifications

IFRS 16 provides guidance on modifications of operating leases by lessors. Modifications to an operating lease should be accounted for from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. [IFRS 16 para 87]. IFRS 16 defines the effective date of a modification as the date on which the parties agree to the modification.

IFRS 16 defines a lease modification as '*A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term)*'. [IFRS 16 App A]. This definition includes agreements to terminate a right of use, including terminations which reduce the remaining lease term to a short period, such as three or six months. Therefore, lessors will need to follow the modification guidance to account for lease payments included in termination agreements.

Modifications to an operating lease should be accounted for from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. [IFRS 16 para 87]. IFRS 16 provides clarity as to the effective date of a modification and defines this as the date on which the parties agree to the modification.

Initial direct costs and lease modifications

Where the guidance in IFRS 16 is applied, while paragraph 87 specifies the accounting treatment for any prepaid or accrued lease payments, it does not set out the treatment for any initial direct costs associated with the lease. This might imply that initial direct costs relating to the original lease are derecognised on modification, and only prepaid or accrued lease payments can be considered as payments related to the new lease. However, IFRS 16 requires a lessor to account for a lease modification as a new lease, and so incremental costs incurred in modifying the lease that fit within the initial direct costs definition could be capitalised, given that they are costs of obtaining the modified lease. These incremental costs would not have been incurred if the lease had not been modified. An alternative view is that, whilst IFRS 16 requires a lessor to account for a modification as a new lease, it contemplates a link to the previous lease by allowing previously recognised prepaid or accrued lease payments to be accounted for as consideration for the modified lease. On this basis, it would follow that any initial direct costs associated with the original lease would equally relate to the modified lease and, therefore, would continue to be recognised and amortised over the remaining term of the modified lease. However, since the definition of initial direct costs refers to costs of obtaining the lease initially, any incremental costs incurred in modifying the lease should therefore be recognised as an expense. Given the absence of specific guidance in IFRS 16, either approach could be followed. An entity therefore has an accounting policy choice. The policy chosen should be consistently applied and disclosed where material.

If non-lease components exist within a contract, a change in the contract terms may modify both the lease and non-lease components. The non-lease component modification would be dealt with under the other relevant standard (for example, IFRS 15 for non-lease services).

For guidance on changes in lease payments that arise as a result of existing terms within a lease contract (for example, exercise of a termination clause that was previously assessed as reasonably certain not to occur), see [section 4.6](#).

Example – Accounting for lease modification where the initial lease contained a rent-free period

Background

Entity A owns and operates a shopping mall. It leases out the shopping mall space to a number of retailers under non-cancellable leases.

Entity A has provided rent-free periods to the lessees during the initial lease period, the effect of which has been accounted for over the lease term in accordance with [paragraph 81 of IFRS 16](#). The leases are classified as operating leases in entity A’s financial statements.

Due to a market downturn, entity A has agreed with a number of its lessees to modify their lease agreements, reducing the fixed rental payments and increasing the contingent rent component.

Prior to the modification, entity A had recognised an accrued lease payment balance that arose from the initial rent-free period. This balance is not considered impaired. Entity A did not have any outstanding operating lease receivables due from tenants at the effective date of the modification.

Question

How should entity A account for the accrued lease payment balance that arose from the initial lease agreement containing the rent-free period following a lease modification?

Answer

The accrued lease payment balance from the original leases represents part of the lease payments for the new lease agreements and, accordingly, it should be deferred and amortised over the new lease terms in accordance with [paragraph 81 of IFRS 16](#).

Example – Accounting for lease modification where payments are received from the tenants on signing a lease termination

Reference to standard: [IFRS 16 para 87](#), [IFRS 16 para 81](#)
Reference to standing text: [15.134](#), [15.136](#), [FAQ 15.136.3](#)
Industry: Real Estate

Background

Entity A owns a commercial investment property and leases out office space to a number of tenants. The leases are generally for 10 years and do not contain any lessee or lessor extension or termination options. The lessor classifies the leases as operating leases.

One of entity A’s tenants starts negotiations to exit their leases early. On 1 December, entity A and tenant X sign an agreement to terminate their lease. Tenant X agrees to pay a termination penalty of C300, payable on 31 December. Tenant X will vacate the premises on 31 May (six-month notice period) and will continue to pay rent of C100 per month (the normal monthly lease payments) each month until it vacates the property.

Question

How should entity A account for a lease modification where payments are due from the tenants on signing a lease termination?

Answer

The amount payable as a termination penalty is in respect of a modification to the lease agreement. The termination was negotiated and amends the original lease agreement, shortening the lease period significantly. The original lease terms have term has been changed in a manner that meets the definition of a lease modification: the lease term has been shortened and there is an additional payment made under the agreement. Under IFRS 16, modifications of operating leases are accounted for as ‘new leases’ from the effective date of the modification (being 1 December) [\[IFRS 16 para 87\]](#). Any payments under the modified lease, including the termination penalties, are lease payments that are recognised as income on a straight-line basis over the term of the lease [\[IFRS 16 para 81\]](#).

This would result in entity A recognising the following amounts for the period to 31 December:

C150 in respect of December rental revenue (= (300 penalty + 6 x 100 monthly rent)/6 months).

4.12.1. Accounting for lease concessions

In certain situations, for example government interventions, economic recession or tenant-specific factors, lessors may grant concessions to lessees. Such concessions might take a variety of forms, including payment holidays, cash rebates and deferral of lease payments. Judgement might be needed to determine the appropriate accounting treatment for these lease concessions. Depending on the facts and circumstances, the substance of the concession might be appropriately accounted for as (negative) variable lease payments, forgiveness of some of the lease payments, deferral of some of the lease payments or a lease modification. Factors to consider in exercising this judgement include the following:

- **Pre-existing clauses in lease contracts.** Some lease contracts contain pre-existing force majeure or similar clauses. Where such a clause applies and results in reduced payments, the substance might be appropriately accounted for as negative variable lease payments that are not dependent on an index or a rate. Under IFRS 16, the effect is recognised by the lessor in the period in which the event or condition, that triggers the reduced payments, occurs.
- **Actions of governments.** IFRS 16 paragraph 2 requires an entity to consider both the terms and conditions of contracts and all relevant facts and circumstances. Relevant facts and circumstances might include contract, statutory or other law or regulation applicable to lease contracts. When applying IFRS 16, an entity treats a change in lease payments in the same way, regardless of whether the change results from the contract itself or from applicable law and regulation. Accordingly, the impact of a lease concession imposed only by law, regulation or government actions might be similar to the impact of a concession required by a pre-existing clause in the lease contract as described above. This might also be appropriately accounted for as negative variable lease payments that are not dependent on an index or a rate, with the effect being recognised by the lessor in the period in which the event or condition, that triggers the reduced payments, occurs.
- **Forgiveness of lease payments.** Where the concession takes the form of a forgiveness of some of the payments, the required accounting for the lessor will depend upon whether the forgiven payments have been recognised as operating lease receivables at the point of forgiveness. IFRS 9 paragraph 2.1(b) requires IFRS 9's impairment and derecognition requirements to be applied to lease receivables. Consequently, prior to forgiveness, the lessor should consider if any expected credit loss provision is required based on its expectations of forgiving lease payments recognised as lease receivables. Upon forgiveness of any amounts already recognised as lease receivables should be accounted for by derecognising the receivable and recognising a loss in the income statement. Any amounts forgiven that relate to future payments that have not been recognised as an operating lease receivable should be accounted for applying the lease modification requirements in IFRS 16. The lessor accounts for a lease modification as a new lease. The concession will impact the total consideration to be received by the lessor over the term of the lease and, as a result, it will change the amount of revenue that the lessor records on a straight-line basis over the lease term. The periods in which no payments are owed by the lessee would be similar to a rent free period granted by the lessor, and similar accounting would result.
- **Deferral of lease payments.** Some concessions might be in the form of the lease payments being rescheduled rather than reduced – such that, in nominal terms, the consideration for the lease has not changed. An entity might judge that, where such a deferral is proportionate, it is not a lease modification, since there is no change in either the scope of the lease or the consideration for the lease. In this case, an operating lessor would account for the nominal payments due under a lease over the lease term on the same basis as before the change (which, for operating leases, is typically straight-line), without considering the impact of the time value of money on the related revenue. Since the modification does not change the total consideration, the amount of revenue to be recognised in each period throughout the lease will not change. However, to the extent that the deferrals result in a build-up of an accrued rent receivable relating to straight-line rent recognition, the lessor should apply the relevant impairment requirements under IAS 36 (for further guidance please refer to [section 4.4](#)).

Entities should also consider what disclosures are required to enable users to understand what the accounting consequences have been of significant lease modifications and any judgements made [\[IAS 1 paras 77, 79\]](#).

4.13. Revenue from managing real estate property

4.13.1. Overview

Real estate entities often provide management services to tenants that occupy the real estate that they hold. Management of real estate might be performed by the real estate owners or by entities designed to provide this service. Real estate management aims to preserve the value of the real estate. The manager is responsible for the oversight of the property, payment of service charges (such as rates, security services and insurance), ensuring that the property is in good condition and performing repairs and maintenance. Any related costs are usually recharged back to tenants. In turn, the manager earns management fees, which can be fixed or directly linked to the performance of the property.

The rendering of services, such as the provision of management services, to customers by real estate managers is within the scope of IFRS 15. IFRS 15 requires the real estate entity to:

- identify the contract(s) with the customer(s);
- identify separate performance obligations in the contract(s);
- determine the transaction price;
- allocate the transaction price; and
- recognise revenue when the performance obligation is satisfied.

Further guidance on these steps and their application can be found in the [PwC Manual of Accounting chapter 11 paragraphs 18–197](#).

Step 1: Identify the contract(s) with the customer(s)

IFRS 15 applies only to contracts with customers. A contract is defined as a written, verbal or implied (for example, by customary business practice) agreement between two or more parties that creates enforceable rights and obligations.

Step 2: Identify separate performance obligations in the contract(s)

Performance obligations are promises in a contract to transfer distinct services, including those that a landlord can resell or provide, to its tenant. A series of distinct services that are substantially the same and have the same pattern of transfer to the tenant (for example, management services) are a single performance obligation, if the following criteria are met:

- each service in the series meets the criteria for a performance obligation satisfied over time; and
- the same method would be applied to measure progress towards satisfaction of the performance obligation to transfer each distinct service in the series to the tenant.

Step 3: Determine the transaction price

The transaction price can be based on the expected value or the most likely amount, but it is constrained up to the amount that is highly probable of no significant reversal in the future. The transaction price is also adjusted for the effects of the time value of money if the contract includes a significant financing component.

Step 4: Allocate the transaction price

The transaction price should be allocated to distinct performance obligations, based on their relative stand-alone selling prices.

Step 5: Recognise revenue when the performance obligation is satisfied

Revenue should be recognised when control over the promised goods or services is transferred to the customer. The amount of revenue recognised is the amount allocated to the satisfied performance obligation.

It is common for real estate entities to involve third parties in providing services to tenants. Where another party is involved in providing services to tenants, entities must assess whether they are acting as principal or agent (see [section 4.13.4](#)).

4.13.2. Measurement of revenue

Revenue for a performance obligation satisfied is recognised in the amount of the transaction price. [\[IFRS 15 para 46\]](#).

Further guidance on the measurement of revenue can be found in the [PwC Manual of Accounting chapter 11 paragraphs 72–73](#).

The transaction price is the consideration that the seller expects to be entitled to in exchange for satisfying its performance obligations, excluding amounts collected on behalf of third parties. Management must determine the amount of the transaction price at contract inception and at each reporting date, taking into account the terms of the contract and its customary business practice. The nature, timing and amount of the consideration promised by the customer determines the transaction price; thus, special consideration is required if contracts contain:

- variable consideration;
- a significant financing component;
- non-cash consideration; or
- consideration payable to the customer.

Variable consideration

Variable consideration should be estimated and included in the transaction price to the extent that it is highly probable that there will be no significant subsequent reversal in the cumulative amount of revenue recognised. This threshold for recognising variable consideration is often referred to as the ‘constraint’ that must be met in order to recognise the variable consideration as revenue.

Variable consideration should be estimated using the expected value approach (probability-weighted average) or the most likely amount, whichever is more predictive in the circumstances. The approach used is not a policy choice, but management should use the approach that it expects will best predict the amount of consideration to which the entity will be entitled, based on the terms of the contract and taking into account all reasonably available information.

The following indicators suggest that including an estimate of variable consideration in the transaction price could result in a significant reversal of cumulative revenue:

- The amount of consideration is highly susceptible to factors outside the entity’s influence.
- Resolution of the uncertainty about the amount of consideration is not expected for a long period of time.
- The entity has limited experience with similar types of contract.
- The entity has a practice of offering a broad range of price concessions or changing payment terms and conditions in similar circumstances for similar contracts.
- There is a large number and broad range of possible consideration amounts.

[IFRS 15 para 57].

Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if the entire estimate of variable consideration is not included because it does not pass the highly probable threshold. Management’s estimate of the transaction price will be reassessed each reporting period, including any estimated minimum amount of variable consideration.

<p>Example – Variable consideration: performance fees</p>
<p>Background</p> <p>A real estate fund manager has a management contract with a fund to provide investment management services for three years. In addition to a base management fee, the manager is entitled to a performance fee that is equal to 20% of profits generated by the investments in the fund when it achieves a return of over 8% per annum. The management agreement states that the performance fee should be calculated, and paid, on the last business day of the third calendar year.</p> <p>Solution</p> <p>The contractual measurement period is based on the terms of the contract, which in this case is three years. In determining whether to include an amount of variable consideration in the transaction price at the end of the first financial period, the manager must assess whether it is highly probable that the amount included will not result in a significant reversal of revenue in future periods (the ‘constraint’). In other words, it is not an ‘all or nothing’ assessment, and entities must always record the highest amount that is highly probable not to result in a significant future revenue reversal. This determination will require judgement and, to the extent that the variable consideration constraint is not met until the end of the year when the performance fee is known, the entire performance fee will only be recognised on the last day of the third calendar year.</p> <p>Amounts received before the constraint criteria are met might need to be recognised as unearned revenue liability (that is, a contract liability).</p>

Significant financing component

In determining the transaction price, an entity should adjust the promised amount of consideration for the effects of the time value of money if the payment includes a significant financing component. In most cases, payments for a service do not include a significant financing component, because an entity (as a practical expedient) does not have to account for such effects if the payment is received within one year after the service has been completed.

4.13.3. Revenue recognition

Revenue is recognised when a performance obligation is satisfied, which occurs when control of a service transfers to the customer. Control transfers either at a point in time or over time, based on a range of criteria.

Recognise revenue over time or at a point in time

Entities should consider whether they meet any of the three criteria necessary for recognition of revenue over time. A performance obligation is satisfied over time where at least one of the following criteria is met:

- The customer receives and consumes the benefits of the entity's performance as the entity performs.
- The entity's performance creates or enhances a customer-controlled asset.
- The asset being created has no alternative use to the entity, but the entity has a right to payment for performance completed to date.

For real estate management services, these will very likely satisfy the first criterion only, since the nature of the services being provided does not create or enhance a customer's asset.

A performance obligation is satisfied at a point in time if it does not meet the criteria above.

Measuring performance obligations satisfied over time

An entity should measure progress of a performance obligation that is satisfied over time using the method that best depicts the transfer of services to the customer. Note that, for a series of distinct goods or services that are accounted for as a single performance obligation (such as a management fee), the same method must be applied to measure progress in satisfying the obligation.

The method selected should be applied consistently to similar contracts with customers. Once the metric to measure the extent to which control has transferred is calculated, it must be applied to total contract revenue, to determine the amount of revenue to be recognised.

4.13.4. Principal/agent relationships

It is common for real estate entities to charge tenants for service costs. Service costs billed to tenants are generally presented gross in the income statement of the real estate entity, unless the entity is acting as an agent on behalf of a third party (for example, as a collector for garbage fees). In line with IFRS 15, property managers will need to reconsider whether they are acting as principal or agent in relation to goods or services that they provide to their tenants. The assessment of whether the landlord is acting as an agent or as a principal with respect to such service costs is to be done on a case-by-case basis, and might depend on the specific jurisdiction of operations.

Paragraphs B34 to B38 of IFRS 15 provide clear guidance on identification of principal-agent relationships. Where another party is involved in providing goods or services to a customer, the entity determines whether the nature of its promise is:

- a performance obligation to provide the specified goods or services itself (principal); or to
- arrange for the other party to provide those goods or services (agent).

An entity is a principal if the entity controls a promised good or service before the entity transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if the entity obtains legal title of a product only momentarily before legal title is transferred to a customer.

The assessment of whether the landlord is acting as principal or as agent is to be determined by applying the two-step approach in paragraph B34A of IFRS 15:

- Step 1: Identify the specific goods or services to be provided to the customer by another party.
- Step 2: Assess whether the landlord controls each specific good or service before that good or service is transferred to the customer.

In some areas, it might be obvious when a landlord is acting as a principal or as an agent. If this is not the case, IFRS 15 provides the following indicators that the entity is a principal:

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service.
- The entity has inventory risk before or after transfer of control to the customer.
- The entity has discretion in establishing prices for the specified good or service and, therefore, obtains substantially all of the remaining benefits.

The indicators in [paragraph B37](#) of IFRS 15 might be more or less relevant

Example – Service costs billed to tenants

Background

Entity A is the owner and lessor of an office building. It is contractually obliged to maintain the premises' car park and provide cleaning, tenants' insurance and security for the building under the terms of its lease contracts with its tenants. The tenants are not charged separately for these services.

Entity A is proposing to report revenue net of the costs incurred to provide the above services.

Is this appropriate, given that these costs are not separately reimbursed by tenants?

Solution

No. Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties are excluded from revenue. However, entity A is not acting as an agent, because it is itself contractually obliged to provide these services to its tenants. As such, it should report revenue on a gross basis.

Entity A is required to assess what lease components and service components are in the contract. Lessors are required to account for the lease and non-lease components of a contract separately. In the case of non-lease components such as service charges, these are accounted for under IFRS 15.

Equally, entity A should also report the costs associated with providing these services gross in the income statement.

Entity A should provide an analysis of the different components of revenue, separating revenue from the sale of services from rental income, either on the face of the income statement or in the notes.

Example – Treatment of taxes and rates received from lessee

Background

Entity A collects local property taxes and water rates, and it pays these to the municipal authorities. These payments are not part of the rental payments receivable by entity A and, in this jurisdiction, tenants retain the primary obligation to the municipality.

Can entity A recognise the receipt and payment of property taxes and water rates on a net basis?

Solution

Yes. Entity A should present the amounts received from its tenants for property taxes and water rates net of the payments that it makes to the municipal authorities. This presentation is appropriate, because entity A acts as an agent on behalf of the authorities. The amounts collected are not revenue, and they are presented in the income statement net of the amounts paid to the municipal authorities. [\[IFRS 15 para 47\]](#).

5. Real estate structures and tax considerations

5.1. Consolidation

5.1.1. Overview

A reporting entity prepares consolidated financial statements where it meets the definition of a group as set out in IFRS 10. The 'group' is 'a parent and its subsidiaries'. IFRS 10 provides a single definition of control that applies to all entities. This definition is supported by extensive application guidance that explains the different ways in which a reporting entity (investor) might control another entity (investee).

The key principle is that control exists, and consolidation is required only if the investor possesses power over the investee, has exposure to variable returns from its involvement with the investee, and has the ability to use its power over the investee to affect its returns. Power over an investee is present where the entity has the right to direct the decisions over relevant activities (that is, the decisions that affect returns).

Relevant activities for a real estate entity include, but are not limited to:

- decision to purchase investment property;
- approval of entering into finance agreements;
- approval of budgets, including maintenance and renovation plans;
- selection of tenants and the approval of lease contracts;
- approval of sale of investment property; and
- investment decisions around investment property.

IFRS 10 provides certain exceptions to the consolidation requirements. One of these exceptions is where the reporting entity is an investment entity. Investment entities are required not to consolidate particular subsidiaries; those subsidiaries are measured at fair value through profit or loss in accordance with IFRS 9.

Determining whether a real estate entity meets the definition of an investment entity requires significant judgement, for which all relevant facts and circumstances (including the purpose and design of the entity) should be considered.

5.1.2. Definition of an investment entity

An investment entity is an entity that:

- obtains funds from one or more investors for the purpose of providing the investor(s) with investment management services;
- commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
- measures and evaluates the performance of substantially all of its investments on a fair value basis. [\[IFRS 10 para 27\]](#).

The definition encompasses the following key elements:

- business purpose including investment-related services;
- exit strategies;
- earnings from investments; and
- fair value measurement.

5.1.2.1. Services

Part of an entity's business purpose might be to provide investment-related services (including investment advisory services, investment management, and investment support and administrative services), either directly or through a subsidiary. These services could be provided to investors and/or third parties. Participating in such investment-related services does not disqualify an entity from being an investment entity, even if these services form a substantial part of its business; this is because such services are an extension of its operations.

The provision of other services that are not investment-related services (such as providing strategic advice or financial support to investees) is one of the factors that differentiates investment entities from other entities. These activities need to be undertaken to maximise investment returns (capital appreciation and/or investment income) from the entity's investees. They must not represent a separate substantial business activity or a separate substantial source of income.

Examples of permissible management and other services for real estate structures are:

- providing management services and strategic advice to an investee;
- providing financial support (such as a loan, capital commitment or guarantee) to an investee;
- other incidental services increasing or enhancing the value of investments; and
- other administrative services (that is, accounting at property level).

[IFRS 10 App B paras B85C, B85D and para BC 240].

For real estate structures, permitted services include the management of the structure and the properties within it, acquisitions, arranging external financing, market analysis, strategic decisions, and marketing of assets for lease or sale.

Typical structures normally use third party service providers (such as property managers) to manage and run the properties, and real estate agents for capital transactions. This has no impact on whether the investment entity exemption is met. Other structures appoint related service providers, especially in portfolio management, who are remunerated at arm's length.

Management services to third party investment property owners should not be a separate substantial business activity, or a separate substantial source of income, for the investment entity definition to be met.

Outside management services, it is often the case that financing (in the form of equity or debt) or guarantees are granted to related holding or property companies within the structure.

5.1.2.2. Business purpose

The definition of an investment entity requires the entity to commit to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both. For real estate structures, capital appreciation is synonymous with the increase in fair value of the properties, culminating in the gains from disposal, whilst rental income from lease contracts is considered as investment income.

The business purpose is normally presented in offering memorandums, prospectuses, term sheets, partnership agreements, deeds or other corporate documents. The objectives are essential in assessing the structure's purpose and whether this purpose is consistent with the business purpose of an investment entity.

Example – Business purpose of an investment entity

Background

A real estate fund, fund F, is a closed-ended fund set up for a limited life of 10 years. The mandate and objective of fund F, set up at inception, is to maximise total returns on capital by seeking consistent recurring income and capital appreciation through acquiring and realising a diverse portfolio of income-producing industrial properties. As such, fund F will be focused on maximising the fair value of its investments and rental income growth. The investments are owned through wholly owned property subsidiaries.

Does the above meet the business purpose of an investment entity criterion?

Solution

Yes. The objective of the fund is to invest funds solely for returns from both capital appreciation and investment income.

5.1.2.3. Exit strategy

Real estate structures are required to have a documented exit strategy for their assets, in order to meet the definition of an investment entity. The presence of an exit strategy is essential evidence of an investment entity's business purpose.

The fact that the investment entity does not plan to hold its investments indefinitely differentiates it from other entities. An entity's objective of investing for capital appreciation is not generally consistent with an objective of holding the investments indefinitely. [IFRS 10 App B para B85F].

An example of an exit strategy includes the sale of the real estate through specialised property dealers or the open market. [IFRS 10 App B para B85G].

Closed-ended real estate structures generally have a limited life, which is expressed in their offering documents, and so the disposal timeframe is transparent. This can be documented in many different ways and in many different types of document (for example, prospectus, marketing material, investor reports and term sheets).

There is no guidance within the standard on the period or the number of years for the exit strategy.

5.1.2.4. Fair value measurement

An essential element of the definition of an investment entity is that the entity measures and evaluates the performance of substantially all of its investments on a fair value basis. Accordingly, presenting its investments at fair value results in more relevant information than consolidation or using the equity method. [IFRS 10 App B para B85K].

To meet this criterion, an investment entity:

- provides investors with fair value information;
- measures substantially all of its investments at fair value in its financial statements whenever it is required or permitted in accordance with IFRS; and
- reports fair value information internally to the entity's key management personnel, who use the fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

[IFRS 10 App B para B85K].

A detailed analysis of the management decision-making process and of the reporting to investors might be required, to understand the primary measurement attributes used.

Some real estate structures, while having other measures, might still use fair value as their primary measurement attribute to evaluate and make investment decisions.

However, where a real estate structure generates substantial investment income (for example, rental income), management might not measure and evaluate the performance of substantially all of its investments on the basis of fair value. In such a case, management and investors might measure the entity's returns in absolute terms, which would include fair value, but fair value would not be the sole primary measurement attribute used in making investment decisions. Yield would typically be another primary measurement attribute. In addition, other measures (such as the internal rate of return, equity multiple, earnings ratio, net present value and EBITDA) might be used. This indicates that the definition of an investment entity is not met, and that consolidation or the equity method would provide more relevant financial information.

5.1.2.5. Typical characteristics of an investment entity

In assessing whether an entity meets the definition described above, it should be considered whether the following typical characteristics of an investment entity are present:

- a. it has more than one investment;
- b. it has more than one investor;
- c. it has investors that are not related parties of the entity; and
- d. it has ownership interests in the form of equity or similar interests.

[IFRS 10 para 28].

Further guidance on these characteristics can be found in the [PwC Manual of Accounting chapter 27 paragraphs 33–40](#).

The absence of one or more of these typical characteristics does not necessarily disqualify the entity from being an investment entity. However, it is highly unlikely that the definition of an investment entity will be met without having any of these typical characteristics. [IFRS 10 para BC 234]. The typical characteristics have to be seen as a supplement to the definition, and real estate structures have to consider whether they display these characteristics.

More than one investment

The purpose of an investment entity is to hold several investments to diversify its risk and maximise its returns. This condition is met if a real estate entity is investing, via a holding company, into several properties or several property-holding entities. [IFRS 10 App B para B85O].

Entities might qualify as investment entities even if they have just one single investment, although the purpose for which the real estate structure has been set up must be taken into consideration.

For example, an entity might have just one single investment in the following situations: during its start-up period, when it only has seed money available; when it is in the course of finding replacements for disposals; or when it is in the process of liquidation. [IFRS 10 App B para B85P]. This can also occur where the entity is established to pool funds from a number of investors to invest in an investment unobtainable by individual investors (for example, a club deal to acquire a substantial iconic property in a core location). Typically, the investment would be out of reach for any single investor, due to its size and risk, but not for a pool of investors.

More than one investor

Typically, an investment entity would have several unrelated investors. However, paragraph B85R of IFRS 10 permits a single investor that represents or supports the interests of a wider group of investors (for example, a pension fund or family trust). Other examples where an investment entity might have only a single investor include the following situations, where an entity:

- a. is within its initial offering period, and is actively identifying other suitable investors;
- b. has not yet identified suitable investors to replace ownership interests that have been redeemed; or
- c. is in the process of liquidation.

[IFRS 10 App B para B85S].

Other typical situations might include master-feeder structures, where there are multiple investors in the feeder funds.

Example – Real estate fund
<p>Background</p> <p>A real estate fund is set up to invest in real estate assets for the benefit of institutional and retail investors. It is set up and managed by an investment manager experienced in the real estate business. The fund invests in real estate companies and other real estate investment funds which own, manage and lease out real estate assets.</p> <p>The investment manager has a policy of acquiring and disposing of its real estate investments over a 5 to 10-year timeframe. The fund earns dividends and it realises capital gains from its real estate investments.</p> <p>The fund reports (internally and externally) all of its investments at fair value, and its performance is assessed based on those fair values.</p> <p>The fund issues redeemable participating units which are redeemable at a share of the fund’s net asset value. The founding documents of the fund confirm its objectives and strategy as stated.</p> <p>Is the fund an investment entity?</p> <p>Solution</p> <p>Yes. The fund meets the definition of an investment entity for the following reasons:</p> <p>Its objective is to generate returns from capital appreciation and investment income through investment management services.</p> <p>It manages its investments on a fair value basis, which is reported to its investors.</p> <p>It displays the typical characteristics of an investment entity, which are: it has more than one unrelated investor; it holds multiple investments; and it has ownership interests in the form of fund units which represent a proportionate share of its underlying assets.</p>

Example – Real estate entity

Background

Real Estate Investments ('REI') was formed in order to develop, own and operate retail, office and other commercial properties.

REI usually holds each of its properties in separate wholly owned subsidiaries. Those subsidiaries have no substantial assets or liabilities other than borrowings used to finance the related investment property.

REI and each of its subsidiaries report their investment properties at fair value.

REI does not have a set timeframe for disposing of properties, although it uses fair value to help identify the optimal time for disposal.

REI and its investors also use measures other than fair value (including information about expected cash flows, rental revenues and expenses) to assess performance and to make investment decisions.

The directors and managers of REI do not consider fair value information to be the primary measurement attribute in evaluating investment performance; rather, they see that information as part of a group of equally relevant key performance indicators.

REI undertakes extensive property and asset management activities (including property maintenance, capital expenditure, redevelopment, marketing and tenant selection), some of which it outsources to third parties. This includes the selection of properties for refurbishment, development, and the negotiation with suppliers for the design and construction work to be done to develop such properties. This development activity forms a separate substantial part of REI's business activities.

Is REI an investment entity?

Solution

No. REI is not an investment entity for the following reasons:

It has a separate substantial business activity that involves the active management of its property portfolio, including lease negotiations, refurbishments and development activities, and marketing of properties, to provide benefits other than capital appreciation and/or investment income.

Its investment plans do not include specified exit strategies for its investments. As a result, it plans to hold those property investments indefinitely.

Although it reports its investment properties at fair value under IAS 40, fair value is not the primary measurement attribute used by management to evaluate the performance of its investments. Other performance indicators are used to evaluate performance and make investment decisions.

(See also [IFRS 10 para IE9](#), example 3.)

5.2. Joint arrangements

5.2.1. Overview

Entities in the real estate industry commonly use joint arrangements in structuring their business and operations.

Joint arrangements exist when joint control is present. Joint control is the agreed sharing of control where decisions over relevant activities require the unanimous agreement of the parties sharing control. It provides entities with a mechanism by which to:

- manage their exposure to particular geographical regions and asset classes;
- share risks in relation to the ownership and/or development of property; and/or
- leverage the expertise, experience and knowledge of the joint arrangement partners.

The structuring of joint arrangements in the real estate industry varies from straightforward arrangements (for example, direct joint ownership of property assets) to more complicated arrangements (for example, joint arrangements to develop and construct property structured through separate vehicles and subject to various contractual agreements).

5.2.2. Classification and measurement of a joint arrangement

Under IFRS 11, there are two types of joint arrangement: joint operations and joint ventures. A joint arrangement is classified as a joint operation where the investors have direct rights to the assets and obligations for the liabilities of the arrangement. A joint arrangement is classified as a joint venture where the investors have rights to the net assets of the arrangement.

Classification of an arrangement determines its accounting treatment: joint operations are accounted for by recognising the operator’s relevant share of assets, liabilities, revenues and expenses; joint ventures are accounted for using equity accounting.

Entities need to assess their rights and obligations under the joint arrangement in order to determine the appropriate classification as either a joint operation or a joint venture.

Investment property that is directly owned as ‘tenants in common’, and not through a separate vehicle, meets the joint operation classification, where joint control exists.

Investment property or development projects undertaken through a separate vehicle (such as a trust, company or unincorporated partnership) will need to be carefully assessed. The accounting for a joint arrangement is not driven solely by its legal form. Operators will account for their involvement in a joint arrangement in a manner that is consistent with their rights and obligations. As such, it is important to understand the contractual terms of the agreements.

Example – Joint arrangements with no separate legal structure

Background

An investment property with a value of C90 was purchased by three investors. Each investor has an equal interest in the property and is listed on the title deed as a tenant in common. Each investor has funded their interest individually, either through external borrowings or through capital. A joint ownership agreement has been signed between the investors to govern their joint ownership of the investment property.

The arrangement is depicted as follows:

- All parties must agree to decisions relating to:
 - the appointment/removal of the property manager;
 - capital expenditure, including the decision to redevelop part or all of the investment property;
 - signing/re-signing major leases;
 - entering into service contracts greater than C0.10 in relation to the property (for example, for cleaning services); and
 - the approval of building insurance.
- Each party is liable for obligations and claims against the property.
- The net property income (NPI) will be distributed to investors based on their ownership interest. NPI is rental income collected by the property manager, less property expenses not recovered by the tenants.

The diagram consists of three orange boxes at the top labeled 'Investor 1', 'Investor 2', and 'Investor 3'. Below each box is a white box containing 'CU30m'. A horizontal line connects these three boxes. A vertical arrow points downwards from the center of this line to a red circular icon containing a white building symbol.

Is the arrangement a joint operation or a joint venture?

Solution

The above is a joint operation under IFRS 11.

The fact that the investors share in the NPI of the investment property does not preclude it from being a joint operation, because each investor has direct rights to the investment property and is liable for obligations and claims arising. Each investor recognises its share of:

- investment property;
- tenants' receivables outstanding at period end;
- trade creditors and accruals outstanding at period end;
- property expenses incurred during the period; and
- rental income generated during the period.

Each investor will also recognise the respective borrowings or additional capital obtained in order to fund the acquisition in their financial statements.

Paragraph BC 27 of IFRS 11 clarifies that it is possible for parties to a joint arrangement, which is not structured through a separate vehicle, to establish terms in the contractual arrangement under which the parties have rights only to the net assets of the arrangement. However, such structures would be very rare in practice.

Example – Joint arrangements structured in a company

Background

Company X was established in the current year by investors A and B, who own 60% and 40% respectively.

The company owns and operates a diversified property portfolio, which it has funded through external borrowings and capital contributed by investors A and B. The legal form of the company restricts the liability of investors to any unpaid capital contributions. Creditors of the company have no recourse against the investors.

The company's articles of association outline that an 85% majority is required for decisions regarding the relevant activities of the company. Each investor votes in proportion to their ownership interest; as such, both investors A and B must unanimously agree on decisions in relation to the company.

Is the arrangement a joint venture or a joint operation?

Solution

The above is a joint venture under IFRS 11. The company is a separate vehicle, which confers separation between the investors and the company itself – that is, the investors are only entitled to their share of the net assets of the company.

Both investors apply equity accounting to their interest in the joint venture.

Example – Joint arrangements structured in an unincorporated partnership

Background

Companies A and B have entered into an arrangement to construct an office building on a parcel of land.

Company A currently owns the land that will be developed as part of the joint arrangement. It will also undertake the development activities in order to construct the office building for a fee. Company A will retain legal title of the land. A development deed is entered into between both companies that provides a beneficial interest in the land to company B. As a result, both companies A and B will have a direct right to the land.

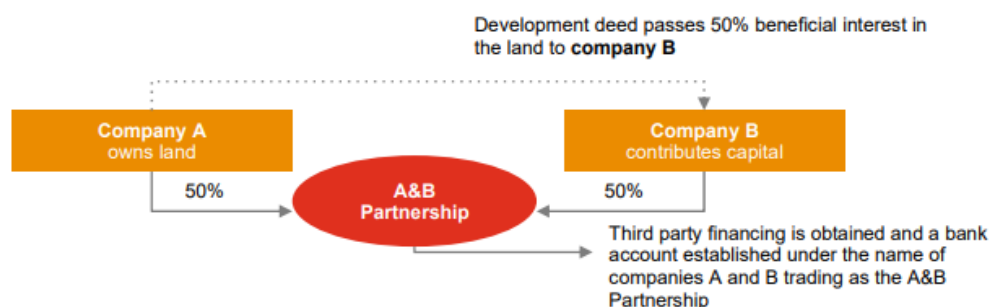
Company B identified the opportunity to partner with company A and will provide capital to the arrangement.

Companies A and B have established an unincorporated partnership to undertake the activities of the joint arrangement. The unincorporated partnership does not create legal separation between the entity itself and companies A and B.

Third party financing has been obtained by companies A and B trading as the A&B Partnership. The financing is secured against the land subject to development; however, companies A and B still have a direct obligation for the third party financing.

A bank account has also been established by companies A and B trading as the A&B Partnership. All payments for the development and receipt of income will pass through this bank account.

Separate books and records are maintained for the A&B Partnership, and financial statements are prepared on an annual basis for distribution to both companies.



Is the arrangement a joint venture or a joint operation?

Solution

The above is a joint operation. While the A&B Partnership is a separate vehicle, companies A and B have direct rights to the assets and obligations for the liabilities of the partnership, because the legal form does not confer separation. Each company will recognise its share of the arrangement's assets, liabilities, revenues and expenses.

The legal structure of an arrangement is not the most significant factor in determining the accounting. Understanding the respective rights and obligations can be challenging, and arrangements need to be carefully considered.

A summary of the requirements is as follows:

Type	Rights and obligations	Accounting
Joint operations	Direct rights to the assets and obligations for the liabilities of the arrangement.	<p>A joint operator will recognise its interest based on its involvement in the joint operation (that is, based on its direct rights and obligations) rather than on the participation interest that it has in the joint arrangement. The balance sheet and income statement will be presented gross.</p> <p>'A joint operator shall recognise in relation to its interest in a joint operation:</p> <ul style="list-style-type: none"> • Its assets, including its share of any assets held jointly. • Its liabilities, including its share of any liabilities incurred jointly. • Its revenue from the sale of its share of the output arising from the joint operation. • Its share of the revenue from the sale of output arising from the joint operation. • Its expenses, including its share of any expenses incurred jointly.' <p>[IFRS 11 paras 20, 26(a)].</p>
Joint ventures	No rights to individual assets or obligations for individual liabilities. Instead, joint venturers share in the net assets and the profit or loss of the arrangement.	<p>Joint ventures are accounted for using the equity method in accordance with IAS 28 unless a scope exclusion applies. [IFRS 11 para 24].</p> <p>In the consolidated financial statements, the net investment in the venture, reflecting the share of net assets, is a single line in the balance sheet; and the share of profit or loss appears as a single line in the income statement.</p>

5.3. Taxation

5.3.1. Overview

The general principles of recognition and measurement of income taxes are set out in IAS 12. IAS 12 applies to all domestic and foreign taxes that are based on taxable profits or taxes on distributions from subsidiaries, joint ventures or associates, such as withholding taxes. [IAS 12 para 2].

5.3.2. Current tax

Current tax is generally recognised as income or expense, unless it arises from a transaction or event that is recognised in other comprehensive income or equity. [IAS 12 para 58]. Since gains or losses on investment property are recognised in the income statement, tax relating to the sale or use of investment property is recognised in the income statement.

Current tax liabilities are recognised for any unpaid tax expense for the current and prior periods. They are measured at the tax rates enacted or substantively enacted at the reporting date.

5.3.3. Deferred tax

Deferred tax arises when expenditure, gains and losses, assets and liabilities are recognised in one period but are included in the computation of taxable profits in future periods. For example, fair value movements on investment property measured at fair value in accordance with IAS 40 are often not taxed until the property is disposed of. The approach to determining a deferred tax asset or liability can be found in the [PwC Manual of Accounting chapter 14 paragraph 18](#).

This can broadly be summarised as follows:

1. Determine tax base.
2. Calculate temporary difference, being the difference between accounting carrying value and tax base.
3. Assess any deductible temporary difference for recoverability.
4. Determine the tax rate that is expected to apply when the temporary difference reverses.
5. Calculate deferred tax, being the temporary difference multiplied by the tax rate.

Deferred tax normally arises from:

- a. fair value movements recognised on investment property carried at fair value; and
- b. the difference between the tax base and carrying value of investment property measured at cost as a result of different depreciation rates being used for tax and accounting purposes.

5.3.4. Deferred tax on investment property measured at fair value

The general principle in IAS 12 is that entities should measure deferred tax using the tax bases and tax rates that are consistent with the manner in which the entity expects to recover or settle the carrying amount of the item. For assets, the carrying amount of an asset is normally recovered through use, or sale, or use and sale. The distinction between recovery through use and sale is important since, in some jurisdictions, different rates might apply for income (recovery through use) and capital gains (recovery through sale). However, for investment property carried at fair value, there is a rebuttable presumption that recovery will be entirely through sale, even where the entity earns rentals from the property prior to its sale. [IAS 12 para 51C].

In order to rebut this presumption, investment property must be depreciable and held as part of a business model whose objective is to consume substantially all of the economic benefits embodied in the property through use over time. An investment property might not qualify for tax depreciation, and no part of the property's cost is deductible against taxable rental income. Instead, the cost of the property (uplifted by an allowance for inflation, where applicable) is allowed as a deduction against sales proceeds for the purpose of computing any taxable gain arising on sale. [IAS 12 para 51C].

Deferred tax for investment properties carried at fair value should generally be measured using the tax base and rate that are consistent with recovery entirely through sale, and using capital gains tax rules (or other rules regarding the tax consequences of sale, such as rules designed to claw back any tax depreciation previously claimed in respect of the asset). If the presumption is rebutted, deferred tax should be measured reflecting the tax consequences of the expected manner of recovery.

The presumption also applies where investment property is acquired in a business combination and the acquirer later uses fair value to measure the investment property. [IAS 12 para 51D].

The freehold land component of an investment property can be recovered only through sale.

Example – Deferred tax on investment property at fair value: clawback of tax depreciation and 0% capital gains tax

Background

On 1 January 20X1, entity A in jurisdiction X purchased an investment property for C100. The investment property does not have a freehold land component. The investment property is subsequently measured at fair value.

At 31 December 20X3, the fair value of the investment property is C120. The tax written-down value is C88 (that is, the accumulated tax depreciation is C12).

The tax legislation in jurisdiction X is as follows:

1. A tax allowance equal to purchase cost is claimed in annual instalments on an investment property held for use.
2. The income tax rate is 30%.
3. Cumulative tax depreciation claimed previously will be included in taxable income if the investment property is sold for more than tax written-down value.
4. Sale proceeds in excess of original cost are not taxed.

What would the deferred tax liability be in each of the following scenarios?

- a. Entity A expects to dispose of the investment property within the next year.
- b. Entity A's business model is to consume substantially all of the economic benefits of the investment property over time, rather than through sale.
- c. Entity A has no specific plans to sell the investment property and holds it to earn rental income, although the investment property might be sold in the future.

Solution

- a. There is a rebuttable presumption that the carrying amount of an investment property measured at fair value will be recovered entirely through sale. This presumption is consistent with management's expected manner of recovery. Entity A recognises a deferred tax liability as follows:

	C
At 31 December 20X3	
Carrying amount at fair value	120
Tax base	(88)
Taxable temporary difference	32
Clawback of tax depreciation below cost (C100-C88 = C12 at 30%)	3.60
Fair value in excess of cost (C120 = C100 = C20) at 0%	0
Deferred tax liability	3.60

- b. If entity A's business model is to consume substantially all of the economic benefits of the property over time, the presumption of recovery through sale may be rebutted. If the presumption of recovery through sale is rebutted, Entity A recognises a deferred tax liability as follows:

	C
At 31 December 20X3	
Carrying amount at fair value	120
Tax base	(88)
Taxable temporary difference	32
Deferred tax liability at 30%	9.60

- c. Entity A has no specific plans to sell the investment property and no business model to consume substantially all of the economic benefits of the property over time, so the presumption of recovery through sale is not rebutted. Deferred tax is determined based on the tax consequences of sale as in scenario A, which is a deferred tax liability of C3.60.

Example – Deferred tax on investment property at fair value: clawback of tax depreciation and capital gains tax

Background

Entity B owns an investment property in jurisdiction Y. The investment property does not have a freehold land component. Entity B has a policy of carrying properties at fair value, and the carrying amount of the investment property is C50 at 31 December 20X0. Entity B acquired the investment property originally for C100 and has claimed tax deductions to date of C40, hence the tax base is C60.

The tax legislation in jurisdiction Y is as follows:

1. Tax deductions claimed are clawed back when the property is sold.
2. Capital gains tax is charged at 15% on the excess of the selling price over the original purchase price.
3. Income is taxed at 30%.
4. Capital losses can only be offset against capital gains.

What would the deferred tax liability be in each of the following scenarios?

- a. Entity B expects to dispose of the investment property within the next year.
- b. Entity B's business model is to consume substantially all of the economic benefits of the investment property over time, rather than through sale.
- c. Entity B has no specific plans to sell the investment property and holds it to earn rental income, although the investment property might be sold in the future.

Solution

- a. Entity B expects to recover the carrying amount of the investment property from sale, which will result in a clawback of the previously claimed allowances of C40. The deferred tax asset (DTA) and deferred tax liability (DTL) are calculated as follows:

	Taxable deductible) temporary difference	Tax rate	DTL/(DTA)
Tax depreciation clawback	40	30%	12
Capital losses (fair value of C50 less purchase price of C100)	(50)	15%	(7.50)

The tax relief on capital losses can only be utilised if there are sufficient capital gains to offset the loss. As such, the deferred tax asset can only be recognised if the criteria in [paragraph 24](#) of IAS 12 are met. Note that, in line with [paragraph 74](#) of IAS 12, the deferred tax liability and deferred tax asset cannot be offset in this case, since jurisdiction Y only allows capital losses to be offset against capital gains.

- b. Entity B is able to rebut the presumption if it has a business model that it will consume substantially all of the property's economic benefits over time, rather than through sale. In this case, entity B will recognise a deferred tax asset of C3 [(C50 – C60) × 30%], subject to the criteria in [paragraph 24 of IAS 12](#).
- c. Entity B has no plans to sell the investment property, and no business model to consume substantially all of the economic benefits of the property over time, so presumption of recovery through sale is not rebutted. Deferred tax is determined based on the tax consequences of sale, as in scenario A.

Example – Deferred tax on investment property at fair value: no tax depreciation with capital gains tax

Background

Entity C acquired an investment property on 1 January 20X0. The investment property does not have a freehold land component. The entity's accounting policy is to measure investment properties at fair value. The cost of the investment property is C50, which is its tax base for capital gains tax purposes.

Management expects to use the property for 10 years, to generate rental income, and to dispose of the property at the end of year 10. The property's residual value at the end of 10 years is estimated to be C20. The fair value of the property is C60 at 31 December 20X0.

The tax legislation in jurisdiction Z is as follows:

1. The cost of an investment property is not deductible against rental income, but any sales proceeds are taxable after deducting the acquisition cost.
2. The tax rate is 30% for taxable income and 40% for capital gains.
3. No annual tax allowance is available on an investment property held for use.

What is the deferred tax liability on initial recognition and at the end of year 1?

Solution

Entity C's business model is not to consume substantially all of the economic benefits of the property over time, given its intention to sell the property in year 10. As a result, the entire property is presumed to be recovered through sale. There is a tax base available on sale, being the purchase price of the property of C50 at acquisition. There is no temporary difference on initial recognition.

At the end of year 1, the fair value of the investment property has increased to C60, with no change in the tax base on disposal. There is a taxable temporary difference of C10. Entity C would recognise a deferred tax liability of C4 ($C10 \times 40\%$) at the end of year 1.

5.3.5. Deferred tax on investment property measured at cost

Investment property carried at cost is depreciated over its useful life for accounting purposes. The rebuttable presumption that the asset will be recovered through sale (noted in [section 5.3.4](#)) does not apply to investment property measured at cost. The expected manner of recovery might be through a combination of use and sale. The asset's carrying amount is split between the use and sale elements, and these carrying amounts are compared to their respective tax bases. If the only tax deduction available for the property is on sale, the tax base of the building's use element carried at cost would be nil on initial recognition and in all future periods. [[IAS 12 para 51](#)].

Example – Deferred tax on investment property at cost

Background

Entity E in jurisdiction E acquired 100% of the shares in entity S for C500 on 31 December 20X0. The identifiable assets acquired included an investment property with a fair value of C250 and other net assets with a fair value of C100.

Entity S purchased the investment property for C180. The cumulative tax depreciation at 31 December 20X0 is C45.

The tax legislation in jurisdiction E is as follows:

1. Gains on disposal (sales proceeds over the original purchase price) are not taxed, but the previously claimed tax allowance is clawed back.
2. The income tax rate is 30%.

What would be the impact, in the consolidated financial statements of entity E, on the recognition of deferred tax on the property and on the goodwill at acquisition, where entity E applies the cost model and assumes recovery of the property through use?

Solution

Entity E should apply the expected manner of recovery principle when the cost model is applied. Since recovery of the property is assumed to be through use, entity E recognises a deferred tax liability on acquisition of C34.50 ($(C250 - C180 + C45) \times 30\%$). The corresponding debit is recognised in goodwill.

5.3.6. Deferred tax on investment property held in a corporate wrapper

In some jurisdictions, investment properties are held in individual legal entities, often referred to as ‘corporate wrappers’.

This allows entities to buy and sell properties without the need to change the legal title or incur any associated stamp duties. Specific structures might also give rise to differences in tax treatment, particularly where the tax rate for the sale of property is different from the tax rate for the sale of shares. These structures give rise to accounting issues around transaction costs and deferred tax.

5.3.6.1. Consolidated financial statements

IAS 12 does not explicitly provide guidance on how to account for deferred taxes where investment properties are held in corporate wrappers. However, in our view, consistent with an agenda decision issued by the IFRS Interpretations Committee in July 2014, management should apply a two-step approach to considering provisions for deferred taxes:

- Level of the legal entity that is the corporate wrapper: management should determine the expected manner of recovery of the underlying property (that is, whether the underlying property will be recovered through use or sale by the corporate wrapper). Management should then determine the temporary difference based on the expected manner of recovery (referred to as the ‘inside basis’ difference) and calculate the deferred tax in the books of the corporate wrapper.
- Level of the consolidated financial statements: management should also identify any additional ‘outside basis’ difference between the accounting carrying value of the subsidiary and its tax base. Deferred tax on the outside basis difference should be recognised if required by [paragraph 39](#) of IAS 12.

This applies even where the group expects to recover its investment in the corporate wrapper without an impact on taxable profit, or with a lesser impact than from selling the property itself (for example, by selling the corporate wrapper). Deferred tax is recognised on the inside basis difference, being the difference between a property’s carrying amount and its tax base. The property itself (not the investment in the corporate wrapper) is recognised in the consolidated balance sheet, so the relevant tax base is that of the asset and not that of the investment.

The outside basis difference arises where the carrying amount of the subsidiary in the consolidated financial statements is different from the tax base, which is often the cost of the investment at the date of acquisition. Outside basis differences usually arise where undistributed profits in the investee increase the carrying value of the parent’s investment in the investee above its tax cost, where the investment’s carrying amount is impaired, or where the investment’s carrying amount changes as a result of changes in foreign exchange rates (for example, where the investee has a functional currency different from the reporting currency). In the context of corporate wrappers, unrealised profits might arise when the underlying property is remeasured to fair value.

However, deferred tax on the outside basis difference might not need to be recognised, because IAS 12 provides an exception from recognising the deferred tax arising on the outside basis difference. The exception applies if:

- the parent controls the timing of the reversal of the temporary difference; and
- it is probable that the temporary difference will not reverse in the foreseeable future.

[IAS 12 para 39].

The carrying amounts for such investments or interests can be recovered through distributions or disposal. Therefore, if the parent has determined that the subsidiary’s profits or reserves will not be distributed in the foreseeable future and the entity will not be disposed of, no deferred tax is recognised on the outside basis difference.

5.3.6.2. Separate financial statements

In the separate financial statements of the entity holding the investment in the corporate wrapper, prepared under IAS 27, deferred tax would be determined on the basis of the carrying value of the investment in the corporate wrapper, since this is the asset recognised on the balance sheet.

Example – Deferred tax on properties held within corporate wrappers

Background

Entity Y holds property X within a corporate wrapper, entity W. The fair value of the property recognised in the consolidated financial statements of entity Y is C10 million and its tax base is C5 million. Entity Y’s management expects the eventual disposal of property X to take place through a sale of entity W, giving rise to a tax charge of C750,000 relating to sale of the investment. If entity Y decided to sell the property by itself, this would give rise to a tax charge in entity W of C1.5 million. This is based on the assumption that the expected manner of recovery of the property is through sale. In addition, entity Y has determined that the exception in

paragraph 39 of IAS 12 applies, so deferred tax is not recognised on any outside basis differences in relation to entity Y's investment in entity W.

How should entity Y recognise deferred tax:

- a. in its consolidated financial statements?
- b. in its separate financial statements?

Solution

- a. Entity Y should record a deferred tax liability of C1.5 million in its consolidated financial statements. In the consolidated financial statements, the property is an asset that gives rise to a temporary difference, and the expected manner of recovery is through selling the asset.
- b. Entity Y should record a deferred tax liability of C750,000 (unless the exemptions in para 39 of IAS 12 apply). In the separate financial statements, it is the investment balance in entity W that gives rise to a temporary difference. Note that, in cases where the investment in a subsidiary is measured at cost and has not been remeasured subsequent to initial recognition, the deferred tax liability might be nil.

5.3.6.3. Deferred tax on initial recognition of corporate wrappers

IAS 12 does not permit the recognition of deferred tax on initial recognition of an asset. [IAS 12 paras 15, 24]. Note that, in consolidated financial statements, this exception does not apply where assets held in corporate wrappers are acquired as part of a business combination (see section 1.1). In the case of an asset acquisition, in line with an agenda decision issued by the IFRS Interpretations Committee in July 2014, the exceptions in IAS 12 in respect of recognition of deferred tax apply. Regardless of whether the acquisition price takes into consideration the benefit of tax implications, no deferred taxes should be recognised. The acquisition price should be allocated solely to the acquired assets pro rata, ignoring any deferred taxes.

5.3.7. Uncertain tax positions

An uncertain tax position is any tax treatment applied by an entity where there is uncertainty over whether that treatment will be accepted by the tax authority. For example, a decision to claim a deduction for a specific expense, or not to include a specific item of income in a tax return, is an uncertain tax position if its acceptability is uncertain under tax law.

IFRIC 23 applies to all aspects of income tax accounting where there is an uncertainty regarding the treatment of an item, including taxable profit or loss, the tax bases of assets and liabilities, tax losses and credits and tax rates:

- If an entity concludes that it is probable that the tax authority will accept an uncertain tax treatment that has been taken or is expected to be taken on a tax return, it should determine its accounting for income taxes consistently with that tax treatment.
- If an entity concludes that it is not probable that the treatment will be accepted, it should reflect the effect of the uncertainty in its income tax accounting in the period in which that determination is made (for example, by recognising an additional tax liability or applying a higher tax rate). The entity should measure the impact of the uncertainty using the method that best predicts the resolution of the uncertainty (that is, the entity should use either the most likely amount method or the expected value method when measuring an uncertainty).

Each uncertain tax treatment is considered separately or together as a group, depending on which approach better predicts the resolution of the uncertainty. IFRIC 23 requires consistent judgements and estimates to be applied to current and deferred taxes.

6. Disposal of investment property

6.1. Classification as held for sale under IFRS 5

Investment property is classified as held for sale under IFRS 5 where its carrying amount will be recovered principally through a sale transaction rather than continuing use. [IFRS 5 para 6].

6.1.1. Overview

For a property to be classified as held for sale, the following conditions need to be met:

the asset must be available for immediate sale in its present condition; and the sale must be highly probable.

[IFRS 5 para 7].

For a sale to be highly probable, management must be committed to a plan to sell the property and have an active programme to locate a buyer and complete the plan. The property must be actively marketed at a price that is reasonable in relation to its current fair value, and the sale should be expected to complete within one year of classification. [IFRS 5 para 8].

For investment property carried at fair value, the measurement provisions of IFRS 5 do not apply. [IFRS 5 para 5(d)]. For investment property under the cost model, measurement under IFRS 5 is at the lower of the carrying amount and fair value less costs to sell. However, for both – investment property under the cost model as well as the fair value model – the presentation and disclosure requirements in IFRS 5 apply.

6.1.2. Property under construction

For property under construction to be classified as a non-current asset held for sale, it is required to be available for immediate sale in its present condition, and the sale should be highly probable and it should occur under normal market conditions.

The criterion of marketability should be particularly scrutinised. If the property cannot be sold as property under construction but only following completion, the investment property is not available for immediate sale in its present condition, because completion is required to reach marketability. If there is, in exceptional cases, a possibility to dispose of the property before the construction is completed, meaning that the property is transferable 'as it is', presentation as held for sale is required, provided that all other conditions in IFRS 5 are met.

6.2. Sale of investment property

Revenue is recognised when a performance obligation is satisfied, which occurs when control of the property transfers to the buyer. The standard provides a list of indicators to consider when determining the point in time at which control passes to the customer, including but not limited to whether:

- the entity has a present right to payment;
- the customer has obtained legal title to the asset;
- the entity has transferred physical possession of the asset to the customer;
- the customer has significant risks and rewards of ownership of the asset; and
- the customer has accepted the asset.

[IFRS 15 para 38]. Further guidance on the satisfaction of performance obligations can be found in the [PwC Manual of Accounting chapter 11 paragraphs 188](#).

Gains on disposal are the difference between the net disposal proceeds, measured in accordance with IFRS 15, and the carrying value of the assets. Such gains are recognised in the income statement (unless IFRS 16 requires otherwise on a sale and lease back). [IAS 40 para 69].

Whereas, in most cases, the disposal proceeds are readily determinable, complications might arise where:

- the agreement includes deferred consideration;
- consideration for the sale includes contingent consideration (that is, consideration dependent on the occurrence of a specific event);
- consideration is variable (for example, consideration that is a percentage of revenue); or
- additional services are provided to the buyer as part of the sale transaction. For example, a vendor might provide transition or other management services to the buyer on an ongoing basis. The vendor might also make head lease payments on vacant space.

The amount of consideration to include in the gain or loss arising from derecognition of an investment property is determined in accordance with the requirements for determining the transaction price in IFRS 15. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring the property to the customer. [IFRS 15 para 47]. Non-cash consideration received is measured at fair value. [IFRS 15 para 66]. The transaction price does not include amounts collected on behalf of third parties. [IFRS 15 para 47].

The consideration promised in a contract to purchase an investment property might include fixed amounts, variable amounts, or both. If the consideration promised in a contract includes variable amounts, an entity estimates the amount of consideration to which it will be entitled in exchange for transferring the property to the customer, excluding amounts for which it is not highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

[IFRS 15 para 56].

See [section 2.6](#) for further information on accounting for variable consideration associated with rental guarantees.

6.2.1. Deferred sales proceeds

Deferred consideration receivable at a later date, for the sale of an investment property that is highly probable of being received and includes a significant financing component, is discounted to present value to arrive at the cash price equivalent using the discount rate that would be reflected in a separate financing transaction at contract inception. This requires the discount rate to include the market interest rate at contract inception as well as the customer's credit risk. The discount rate is not adjusted for changes in interest or other circumstances at a later stage. [IFRS 15 para 64]. The difference between this amount and the amount receivable is treated as interest income, and it is recognised, over the period until the actual receipt, using the effective interest method.

[IFRS 15 para 65].

However, for deferred consideration to include a significant financing component, the criteria in [paragraph 61 of IFRS 15](#) need to be met. A significant financing component does not exist if:

- the amount or timing of the deferred consideration varies on the basis of the occurrence or non- occurrence of a future event that is not (substantially) in the control of either the customer or the entity; or
- the deferred consideration arises from reasons other than the provision of finance to either the customer or the entity, and the difference between the promised consideration and the cash selling price is proportional to the reason for the difference.

[IFRS 15 para 62].

As a practical expedient, an entity need not adjust for the promised amount of consideration, for the effects of a significant financing component, if the entity expects the financing period to be one year or less. [IFRS 15 para 63].

Example – Treatment of deferred sales proceeds that contain a financing component

Background

Investment property entity T has recently sold a property for C12 million. The sale agreement provides for C10 million to be remitted at the date of legal completion of the sale, with the remaining C2 million payable after one year. The market rate of interest for 12-month loans to entities with a similar credit rating to the buyer is 7%.

Is entity T required to discount deferred sales proceeds to their net present value?

Solution

Yes, the arrangement effectively constitutes a financing transaction. Entity T should record an amount receivable of C1,869,159 ($C2,000,000/1.07$). It would recognise the difference between C1,869,159 and C2,000,000 as interest income over the 12-month period using the effective interest method.

6.2.2. Variable consideration on a sale of property

Example – Treatment of deferred sales proceeds that are in proportion to an outstanding service

Background

Investment property entity U has recently sold a property for C12 million. The sale agreement provides for C10 million to be remitted at the date of legal completion of the sale, with the remaining C2 million payable after the completion of the outdoor facilities. The amount held back is equivalent to the calculated stand-alone selling price for the outstanding construction works.

Is entity U required to discount deferred sales proceeds to their net present value?

Solution

No, the arrangement does not constitute a financing transaction. Entity U should assess whether the transfer of the completed outdoor facilities is part of a separate performance obligation, or whether it is part of the single performance obligation that transfers the property as a whole. Furthermore, the entity needs to assess whether the performance obligation is, or the performance obligations are, satisfied at a point in time or over time.

If the entity concludes that there are two performance obligations (being the transfer of the property followed by the completion of the outdoor facilities at the property), it would account for C10 million as revenue when the property is transferred. The remaining C2 million would be recognised as revenue over time, because the completion of the outdoor facilities enhances an asset that the customer controls.

If the entity concludes that the amount has been deferred with a view to protecting the customer from the entity inadequately completing the outdoor facilities, the entity recognises C12 million if it expects to complete all of its obligations under the contract.

The entity needs to consider the accounting for more complicated recognition and measurement items in accordance with relevant standards.

6.3. Sale of property under construction

Cash receipts do not necessarily indicate that the entity is able to recognise revenue. Revenue is recognised under IFRS 15 when a performance obligation is satisfied, which occurs when control of a good or service transfers to the customer. Control can transfer either at a point in time or over time, based on a range of criteria. An entity should determine at contract inception whether control of a good or service is transferred over time or at a point in time.

An entity might begin activities on an anticipated contract, prior to the arrangement meeting the criteria of IFRS 15 to be recognised as a contract with a customer. Revenue should be recognised on a cumulative catch-up basis if subsequent reassessment indicates that the criteria are met. This cumulative catch-up should reflect the performance obligation(s) that are partially satisfied, or satisfied on the contract reassessment date. An entity will need to determine the goods or services that the customer controls and, therefore, what portion of the costs are included in any measure of progress, to determine the cumulative revenue recognised.

6.3.1. Recognise revenue over time or at a point in time

Real estate developers will need to consider whether they meet any of the three criteria necessary for recognition of revenue over time.

A performance obligation is satisfied over time where at least one of the following criteria is met:

- The customer receives and consumes the benefits of the entity's performance as the entity performs.
- The entity's performance creates or enhances a customer-controlled asset.
- The asset being created has no alternative use to the entity, but the entity has a right to payment for performance completed to date.

Without discussing all of the indicators above, a common judgement in the real estate industry is whether the entity has an enforceable right to payment for performance completed to date. This is discussed in the example below.

A performance obligation is satisfied at a point in time if it does not meet the criteria above.

Determining when control transfers will require significant judgement. Indicators that might be considered in determining the point in time at which control of the good or service (asset) passes to the customer include, but are not limited to whether:

- the entity has a present right to payment;
- the customer has obtained legal title to the asset;
- the entity has transferred physical possession of the asset to the customer;
- the customer has significant risks and rewards of ownership of the asset; and
- the customer has accepted the asset.

Example – Right to payment

Background

A property developer signed sales and purchase agreements to sell specific apartments in an apartment block to different customers during the construction phase. Once the contract has been signed, the developer cannot redirect the unit to another customer. All customers are required to pay a 10% non-refundable deposit, and pay the remainder of the transaction price based on milestones as determined in the contract. The performance does not create an asset with an alternative use.

If a customer defaults, the property developer will be entitled to 10% of the contract price, and it can retain the work in progress completed to date. Any cash received above 10% will be refunded to the customer. How should the developer recognise revenue from the sale of the apartment to the customer?

Solution

Revenue is recognised over time if the apartment being constructed has no alternative use and the seller has a right to payment for the duration of the contract. While this assessment will need to be made on a contract-by-contract basis, in this example the apartment will meet the 'no alternative use' test, because the specific unit cannot be redirected contractually.

The second criterion is that of a right to payment for performance to date. The entity must be entitled to an amount that at least compensates it for performance completed to date, at all times throughout the duration of the contract, if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. The right to receive a penalty and the right to retain the work in progress are not considered to provide the developer with a right to payment for work completed to date, but are merely a payment of a deposit or a payment to compensate the entity for inconvenience of loss of profit. There is therefore no right to payment for work completed to date established in this contract. The entity should evaluate when control passes to the customer, and it should recognise revenue on this date.

6.3.2. Significant financing component

An entity adjusts the promised amount of consideration where there is a significant financing component. If the contract contains a significant financing component, the transaction price should reflect the time value of money. An entity is not required to consider the time value of money if the period between payment and the transfer of the promised goods or services is one year or less, as a practical expedient.

In assessing whether a contract contains a significant financing component, an entity should consider various factors, including:

- the length of time between when the entity transfers the goods or services to the customer and when the customer pays for them;
- whether the amount of consideration would substantially differ if the customer paid cash when the goods or services were transferred; and
- the interest rate in the contract and prevailing interest rates in the relevant market.

Example – Time value of money		
<p>Background</p> <p>A contractor enters into a contract for the construction of a building on the customer’s land. This construction of the building is a single distinct performance obligation. Control passes to the customer over the contract term. The contract terms indicate specific dates on which the customer is required to make certain payments. These payments do not necessarily coincide with the performance by the contractor. The following milestones are established:</p>		
Month of payment	Amount paid	Month in which the associated construction is performed
1	C10 million	0–6
15	C50 million	7–13
13	C20 million	14–18
<p>The contract is set up in this way so that the contractor has the necessary funds to cover the cost of construction.</p> <p>Solution</p> <p>The contractor charges the customer in advance. Management will need to consider the time period between payment and the completion of the related performance, where the contractor is performing over time rather than at a specific point in time, to assess whether there is a significant financing component, taking into account the 12-month practical expedient offered by the standard. For example, the contractor might receive payment in month 5 but would perform over the period between month 7 and month 13, and thus there might not be a 12-month period between the date of payment and the associated performance. However, if there is a significant financing component, the contractor will need to assess whether a significant financing transaction exists. If a significant financing transaction does exist, the entity should calculate this finance component.</p>		

6.3.3. Measuring the progress towards completion

An entity should measure progress toward satisfaction of a performance obligation that is satisfied over time using the method that best depicts the transfer of goods or services to the customer. Methods for recognising revenue, when control transfers over time, include the following:

- Output methods that recognise revenue on the basis of direct measurement of the value to the customer of the entity’s performance to date (for example, surveys of goods or services transferred to date, contract milestones, or appraisals of results achieved).
- Input methods that recognise revenue on the basis of the entity’s efforts or inputs to the satisfaction of a performance obligation (for example, cost-to-cost, labour hours, labour cost, machine hours, or material quantities).

The method selected should be applied consistently to similar contracts with customers. Once the metric is calculated to measure the extent to which control has transferred, it must be applied to total contract revenue to determine the amount of revenue to be recognised.

Example – Measure of progress towards complete satisfaction of performance obligation

Background

A developer is constructing a high-rise apartment building. All units have been sold off-plan before construction commenced. The ground floor units are completed in December 20X1, but the top floor apartments are completed in June 20X2. There is a restriction on the purchasers from occupying the units until the entire building is complete, and the safety inspection, which is required by the relevant regulations, has been performed.

Assume that there is only one performance obligation (the unit). Further, assume that the criteria for recognising revenue over time have been met (since the units have no alternative use), and the developer has an enforceable right to payment for work completed to date, based on the contractual terms and an assessment of applicable legislation and legal precedent in the jurisdiction where the property is located. How should the developer recognise revenue from the sale of the units?

Solution

The developer has sold the individual units to individual customers. Each individual unit is a separate contract that includes a performance obligation that is satisfied over time. The developer would account for each contract separately; however, in practical terms, the progress towards completion for each unit could be calculated by reference to the stage of completion of the apartment block as a whole.

The analysis would be different if the developer had not sold all of the units off-plan before construction commenced. Revenue would not be recognised on unsold apartments, and costs associated with unsold apartments would be recorded as inventory.

It is also unlikely that this method would be appropriate if the developer was selling detached houses in a new estate, rather than apartments in a single building. This is because the completion of one house would probably not be dependent on the completion of another. Provided that the criteria for revenue recognition over time are met for the sale of each individual house, revenue would be measured based on the stage of completion assigned to each individual house, rather than a single stage of completion being assigned to the development as a whole, as in the case of an apartment block.

Example – Partial satisfaction of performance obligations

Background

An entity begins constructing an apartment building and pre-sells 60% of the units. The asset has no alternative use, and the entity has a right to payment for work completed to date from the time at which the contract is signed. The remaining 40% of the units are constructed for inventory. At a later date, after the shell of the rooms of all floors of the apartment building has been completed, the entity enters into a new contract with a customer to sell one of the remaining units on the same terms as the original contracts. Thus, at inception of the new contract, a portion of the new customer's unit is already completed.

Solution

A cumulative catch-up adjustment is consistent with the principle of the standard of recognising revenue to depict an entity's performance in transferring control of goods or services to the customer. Thus, if activities performed prior to the contract establishment date have resulted in progress towards satisfying a performance obligation, the entity would recognise the revenue that it expects to be entitled to for that progress completed to date.

7. Other reporting issues

7.1. Functional and presentation currency

7.1.1. Overview

IAS 21 requires an entity to determine its functional currency and to measure its results and financial position in that currency. The functional currency serves as the basis for determining whether the entity is engaging in foreign currency transactions. IAS 21 defines foreign currency as a currency other than the functional currency. Identifying the functional currency has a direct impact on which transactions are foreign currency transactions that give rise to exchange gains and losses and, thereby, on the reported results.

The standard permits an entity to present its financial statements in a currency other than its functional currency. The currency in which the financial statements are presented is referred to as the 'presentation currency'.

7.1.2. Functional currency

The functional currency is the currency of the primary economic environment in which the entity operates. [IAS 21 para 8]. The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash.

The functional currency determination is generally straightforward for a simple investment property entity operating in a single country. As investment property entities become more complex, this can also increase the complexity of determining the functional currency.

A listed investment property fund might be domiciled in a particular country, its shares traded on the country's stock exchange and denominated in the local currency. However, it might not hold all or any of its investment properties in that country. The currency of the primary operating environment is the most relevant factor in determining functional currency.

Further guidance on determining functional currency can be found in the [PwC Manual of Accounting chapter 49 paragraph 10](#). The primary indicators of functional currency are:

- It is the currency that mainly influences the sale prices of goods and services. For example, if an entity owns only one property in country X, by which it earns rental in country X's currency, this would indicate that country X's currency would be the functional currency of the entity.
- It is the currency of the country whose competitive forces and regulations mainly influence the sales prices of goods and services. In the above example, the competitive forces in country X would drive the determination of sales price.
- It is the currency that mainly influences labour, material and other costs.

[IAS 21 para 9].

Where the above factors are not clear, the following factors are also considered:

- It is the currency in which funds from financing activities (such as issuing debt or equity) are generated.
- It is the currency in which receipts from operating activities are retained (that is, the currency in which the entity maintains its working capital balance).

IAS 21 provides the following additional factors for consideration when determining the functional currency of foreign operations held as subsidiaries:

- The degree of autonomy of a foreign operation from its parent entity.
- Whether transactions with the parent are significant.
- Whether cash flows of the foreign operation are readily available for remittance to the parent.
- Whether the foreign operation can meet its debt obligations without the support of the parent.

[IAS 21 para 11].

Further guidance on determining the functional currency of foreign operations can be found in the [PwC Manual of Accounting chapter 49 paragraph 11](#).

7.1.3. Presentation currency

An entity can choose to present its financial statements in any currency. There is no requirement in the standard for an entity to present its financial statements in its functional currency.

Where the entity has a different presentation currency from its functional currency, it translates its financial statements from functional currency to presentation currency as follows:

- assets and liabilities are translated at the closing rate;
- income and expenses are translated at exchange rates at the transaction dates; for practical reasons, most entities use average rates of the period as an approximation; and
- all resulting differences are recognised in other comprehensive income.

Example – Determination of functional currency: operations and capital in different countries

Background

Entity X invests primarily in investment properties in the United States. Entity X is incorporated in the Netherlands. All acquisitions and divestments of properties are undertaken in US dollars (USD). Entity X is an autonomous entity and makes all operational decisions in relation to the investment properties that it holds. Rental agreements are in USD. The entity is financed in euros (EUR); reporting to the European-based investors is also in EUR. The shareholder base of Entity X is relatively fixed, and changes in shareholders are infrequent.

What is the appropriate functional currency for an investment property entity with operations in different countries?

Solution

The appropriate functional currency for entity X is USD. It represents the most relevant currency, because it is the currency that mainly influences its rental revenue and expenses.

Given the nature of the entity, the primary indicators for this type of entity are significant. Provided that these indicators are conclusive, there is no need to consider the currency in which its financing activities are generated and in which its receipts from operating activities are usually retained.

Entity X can choose to present its financial statements in EUR.

Example – Determination of functional currency: investment properties in various countries (1)

Background

Investment property entity Y is domiciled in Switzerland. Entity Y's shares are denominated in Swiss francs (CHF) and are traded on the local stock exchange. Entity Y invests principally in investment properties in countries having EUR as their national currency. The entity also invests, directly, approximately 10% of its funds in Russia, but 90% of its income and revenue expenditure is determined and denominated in EUR. Entity Y is an autonomous entity. Its debt is denominated in EUR and its financial statements are presented in CHF.

What is the appropriate functional currency for an investment property entity with investments in various countries?

Solution

The appropriate functional currency for entity Y is EUR. It represents the most relevant currency, because it is the currency that mainly influences its rental revenue and related expenses.

Example – Determination of functional currency: investment properties in various countries (2)

Background

A real estate entity operates in Russia. It owns several office buildings in Moscow and St Petersburg that are rented to Russian and foreign entities. All lease contracts are denominated in USD, but payments can be made either in USD or in Russian roubles (RUB). However, almost all of the lease payments are settled in RUB. This has also been the historical pattern of payment.

What is the appropriate functional currency for the investment property entity?

Solution

The 'sales and cash inflows' indicators produce a mixed response:

- a. The currency that mainly influences the pricing of the lease contracts is USD, whereas the cash inflows are in RUB.
- b. Cash outflows (such as the principal operating costs, management of properties, insurance, taxes and staff costs) are likely to be incurred and settled in RUB.

The lease payments are denominated in USD, but US dollars are not considered to be significant to the entity's operation, because:

- a. most of the collection is in RUB, which is subject to short-term changes in USD/RUB exchange rates; and
- b. it is the local conditions and circumstances in Russia, and not in the US, that determine the rental yields of properties in Moscow and St Petersburg that mainly influence the pricing of the lease contracts, which are merely denominated in USD.

It is, therefore, the currency of the Russian economy, rather than the currency in which the lease contracts are denominated, that most faithfully represents the economic effects of the real estate activity in Russia.

Example – Functional currency of a special purpose entity

Background

Entity B is a real estate entity that has been set up by a European-based investor to serve the specific business needs of this investor. The functional currency of the investor is EUR.

In accordance with the agreed investment strategy set by the investor, entity B invests 85% of its net assets in US property. The remaining investments are widespread. The redemption of shares will be executed in USD.

Solution

The functional currency of entity B is EUR. Although the entity is mainly invested in the US market, its activities are simply an extension of the activities of the investor. The entity does not operate with a significant degree of autonomy. Consequently, its functional currency is that of the investor.

7.2. Cash flow statement

7.2.1. Overview

IAS 7 requires all entities to prepare a cash flow statement as an integral part of their financial statements for each period for which financial statements are presented. The cash flow statement reports changes in cash and cash equivalents in the period, classifying these as arising from operating, investing or financing cash flows.

7.2.2. Definition of cash and cash equivalents

Cash and cash equivalents comprise cash on hand and demand deposits, as well as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. [IAS 7 para 6]. Cash and cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. [IAS 7 para 7].

Cash and cash equivalents must be readily convertible to known amounts. Funds subject to restrictions on use, such as deposits received from lessees, or cash held in blocked accounts, will be presented as cash and cash equivalents in the statement of financial position and in the cash flow statement when they meet the definition of either cash or cash equivalents, which will depend on the nature and severity of the restrictions. An entity may disaggregate cash and cash equivalents subject to contractual restrictions in the statement of financial position

when this information is relevant to an understanding of the financial position. Disclosure of restrictions on cash or cash equivalents may also be required.

Example – Accounting for blocked accounts in the statement of cash flows

Background
 Entity A is generating property rental income. On 31 December 20X1, it sold real estate property X for C10, of which:

- C8 is transferred from the purchaser directly to a blocked account;
- and the remaining C2 is paid to entity A at the sale date.

The amounts in the blocked account will be used to settle Entity A's bank borrowings for property X in six months' time. This will legally release Entity A from its obligation to settle the liability. Entity A is not able to use the amounts transferred to the blocked account for any other purpose than to repay the bank borrowings and therefore, the bank's approval is required for release of funds. The entity does not routinely sell real estate property.

How should the amounts held in the blocked account be recorded in Entity A's statement of cash flows?

Solution
 Entity A will first assess whether the funds in the blocked account meet the definition of cash. As they are not available on demand by Entity A and require approval by a third party the funds do not meet the definition of cash. Given the nature of Entity A's operating activities, it should disclose the cash inflow of C10 from the sale of the investment property as part of investing activities. However, the amount of C8 should be recorded as a non-cash transaction in investing activities, with adequate disclosure given in the notes. [IAS 7 para 43]. When the entity receives the cash and repays the loan in the following year, it should recognise the remaining proceeds and the repayment of borrowings.

Extract from the cash flow statement as of 31 December 20X1

Cash flow from investing activities	Current year
Proceeds from sale of investment property	+ C2
Cash outflow from non-cash equivalent investment	–
Cash flow from investing activities	C2

Extract from the cash flow statement as of 30 June 20X2

Cash flow from investing activities	Current year
Proceeds from sale of investment property	+ C8
Cash flow from investing activities	C8

Cash flow from investing activities	Current year
Cash outflow from repayment of long-term borrowings	– C8
Cash flow from investing activities	C8

Further guidance on cash flows from operating activities can be found in the [PwC Manual of Accounting chapter 7 paragraphs 19–26](#).

Further guidance on cash flows from investing activities can be found in the [PwC Manual of Accounting chapter 7 paragraphs 27–29](#).

Further guidance on cash flows from financing activities can be found in the [PwC Manual of Accounting chapter 7 paragraphs 30–32](#).

7.2.3. Classification of lessor cash flows in the cash flow statement

Generally, acquisitions and disposals of long-term assets would be classified as investing cash flows; however, entities that routinely acquire or manufacture assets with a view to rent and subsequent sale should classify the relevant cash flows as operating cash flows. Whether assets are 'routinely' held for sale is a matter of judgement.

[IAS 7 para 16]. [IAS 7 para 14].

For example, if a real estate entity routinely acquires investment property with a view to rent and then subsequently sell or lease under finance leases (as part of the business model in making the investment), cash flows such as finance lease receipts, payments to purchase the investment property and receipts from subsequent sale of the property would be classified as operating cash flows. Occasional or opportunistic sales of investment property within a portfolio alone would not indicate a business purpose to rent and subsequently sell investment property upon acquisition.

If entities do not routinely acquire investment properties with a view to rent and subsequent sale, for example, the business model in acquiring the property is for long term rentals, the cash flows associated with the original purchase or the sale of the underlying property would be investing. Similarly, if the property is disposed of through a finance lease, receipts representing repayment of the principal would also be investing. This is on the basis that they are, in substance, the disposal of a long-term asset, because the fair value of the underlying asset is recovered through regular payments over time with the same counterparty. For operating leases, since they do not involve the disposal of a long-term asset, lease receipts would generally be considered operating cash inflows.

Paragraph 14 of IAS 7 requires cash flows that are primarily derived from the principal revenue-producing activities of the entity to be classified as operating activities. Paragraph 16 of IAS 7 requires acquisitions and disposals of long-term assets to be classified as investing cash flows. So a contradiction arises when an entity has leasing as its principal operating activity: paragraph 16 of IAS 7 would suggest that the cash outflow in acquiring assets to lease out would be investing, but paragraph 14 of IAS 7 suggests that the cash outflow deriving from an entity's primary operating activities would be operating. In this case, we consider it acceptable for entities either to classify the cash outflow as investing (in line with Paragraph 16 of IAS 7) and the rental inflow as operating, or to deem both the cash inflow and outflow as operating. An accounting policy should be developed and applied on a consistent basis.

8. Disclosures

8.1. Revenue and lease income

The objective of the disclosure requirements is for an entity to disclose sufficient information in the notes that, together with the information provided in the statement of financial position, income statement and statement of cash flows, enables users of financial statements to:

- understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers; and
- assess the effect that leases have on the financial position, financial performance and cash flows of the lessor.

Additional information on the disclosure requirements

Please refer to [PwC's Illustrative IFRS consolidated financial statements 2022 for Investment Property](#).

8.1.1. Revenue income disclosures

Revenue income disclosures consist of qualitative and quantitative information about all of the following:

- an entity's contracts with customers;
- the significant judgements, and changes in the judgements, made in applying [IFRS 15](#) to those contracts; and
- any assets recognised from the costs to obtain or fulfil a contract with a customer.

[\[IFRS 15 para 110\]](#).

For a real estate entity, this requires revenues recognised from contracts with customers to be disclosed separately from its other sources of revenue and separately from the lease income received. [\[IFRS 15 para 113\(a\)\]](#). The real estate entity also provides disclosure on revenue that it disaggregates into categories. The extent to which an entity's revenue is disaggregated for the purpose of this disclosure depends on facts and circumstances and the nature of the entity's contracts with its customers.

Further information to be disclosed includes:

- contract balances, such as opening and closing balances for receivables, contract assets and contract liabilities;
- performance obligations (for example, a description of when the company typically satisfies its performance obligations, and the significant terms and conditions);
- the allocation of transaction prices, including the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied at the end of the reporting period;
- significant judgements in the application of the standard; and
- assets recognised from the costs to obtain or fulfil a contract with a customer.

8.1.2. Lease income disclosures

IFRS 16 includes a number of disclosure requirements relating to leasing activity by lessors. Lessors must disclose qualitative and quantitative information about leasing activities, namely:

- the nature of the lessor's leasing activities; and
- how the lessor manages the risk associated with any rights that it retains in underlying assets.

For operating leases, a lessor presents – in a tabular format – the lease income received, separately disclosing the income relating to variable lease payments that do not depend on an index or rate. [\[IFRS 16 paras 90\(b\), 91\]](#). The lessor also discloses a maturity analysis of lease payments. [\[IFRS 16 para 97\]](#). This maturity analysis is of the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years, and a total of the amounts for the remaining years. The lessor is also within the scope of disclosure requirements in [IAS 16](#), [IAS 36](#), [IAS 38](#) and [IAS 40](#) for the underlying assets provided under these leases. [\[IFRS 16 paras 95–96\]](#).

With respect to finance leases, the lessor discloses a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases. [\[IFRS 16 para 93\]](#). With respect to the

maturity analysis for a finance lease, the lessor also reconciles the undiscounted lease payments to the net investment in the lease. [IFRS 16 para 94].

These disclosures are in addition to the disclosure requirements in IFRS 7 which requires disclosures for all finance lease receivables as well as operating lease receivables. This requires, among other things, disclosure of information on the credit risk of lease receivables and the maximum exposure to credit risk.

8.2. Segment disclosures

Public entities are required to disclose, in their financial statements, information regarding the nature and financial effects of activities in which they engage and the economic environments in which they operate. The disclosures should be consistent with the information presented to the entity's chief operating decision-maker (CODM). Information is presented for the entity's reportable segments.

8.2.1. Definitions

An operating segment is a component of an entity:

- that engages in business activities from which it can earn revenues and incur expenses;
- whose operating results are regularly reviewed by the entity's CODM to make decisions about resources to be allocated to the segment and assess its performance; and
- for which discrete financial information is available.

[IFRS 8 para 5].

A reportable segment is an operating segment that:

- generates revenue – from both sales to external customers and inter-segment sales or transfers – exceeding 10% of combined revenues;
- has an absolute net profit of 10% of the combined reported profit of the segments that report a profit;
- has an absolute net loss of 10% of the combined reported loss of the segments that report a loss; or
- has assets exceeding 10% of combined assets of all operating segments.

Management discloses information about each reportable segment. Once an entity has identified the reportable operating segments, it can combine information about the remaining operating segments to produce a reportable segment. This is possible only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria in IFRS 8. [IFRS 8 para 14].

8.2.2. Considerations for operating segments in real estate: managing properties on a portfolio basis

A real estate entity might have only one operating segment – for example, if the entity's only business activity is that of investing in similar real estate properties in a specific geographical area with similar tenants. In such a case, the properties might be managed together, and the CODM might regularly review the portfolio's operating results and performance on a combined basis, with decisions about resources to be allocated also being made at that level.

Even if the real estate entity comprises less uniform properties, the CODM might review the performance of, and allocate resources to, the portfolio together. Ultimately, an entity's operating segments are determined 'through the eyes of management'.

Even if a real estate entity has only one operating segment, it will still need to present segment information to satisfy the minimum requirements of IFRS 8. [IFRS 8 para 31]. Disclosure is required of revenues from external customers for each product or service, or each group of similar products and services. However, if a real estate entity has only one operating segment, it would not be required to disclose revenue on a property-by-property basis. [IFRS 8 para 32].

8.2.3. Considerations for operating segments in real estate: managing real estate on a property-by-property basis

In some cases, real estate entities manage their real estate portfolio on a property-by-property basis.

Each property would be an operating segment if the CODM reviews the results and performance of the properties on a property-by-property basis and makes decisions about resources to be allocated to the properties on the same basis.

However, if only the day-to-day management is performed on a property-by-property basis, but the CODM does not use this information and does not assess performance on a property-by-property basis, the entity's operating segments would be determined on the same basis as that used by the CODM.

There is, in theory, no limit on the number of operating segments that an entity can have, given that these are based on reporting to the CODM. However, IFRS 8 states that an entity with more than 10 reportable segments should consider whether a practical limit of reportable segments has been reached. [IFRS 8 para 19]. Entities with a significant number of reportable segments should consider aggregating segments.

Examples of single properties which might be operating segments are as follows:

- A single asset in the US could be an operating segment, if all other real estate assets are located in Europe and information about the asset is reported separately to the CODM.
- A single logistics asset could be a stand-alone operating segment, if all other assets in the real estate entity's portfolio are office buildings, and information about the logistics asset is reported separately to the CODM.

8.2.4. Matrix information provided to the CODM

The CODM of a real estate entity might receive information that aggregates the portfolio of property according to different criteria. Such information might be distinguished by property type or by geographical area.

If the CODM uses more than one set of segment information, the real estate entity needs to determine which component constitutes the operating segment. Factors that can be considered include the nature of the business activities of each component, the risks and rewards profile, the existence of managers responsible for them, and information presented to the board of directors. [IFRS 8 para 8].

If the CODM uses overlapping sets of components (for example, it manages the company's activities on a matrix basis), the entity should determine which set of components best constitutes the operating segments by reference to the core principle in IFRS 8. [IFRS 8 para 10].

8.2.5. Criteria used to determine operating segments

Depending on how a real estate entity is managing its properties, the CODM might receive information on the following basis:

- Types of property: office buildings, logistics, retail areas, warehouses, hotels, retail housing, etc.
- Nature of the attached business model: developed properties, properties under development, non-development property.
- Nature of management: individually managed properties, properties managed on a portfolio basis.
- Location of properties: Europe/US/Asia, town centre/inner suburbs/outer suburbs.
- Types of tenant: retail, corporate, governmental.
- Number of tenants: multiple-tenant property, single-tenant property.
- Types of investment: direct property investments, indirect property investments.

8.2.6. Aggregation

Aggregation

Operating segments that meet the quantitative threshold (as explained in section 8.2) could be aggregated into a single operating segment if aggregation is consistent with the core principle of paragraph 12 of IFRS 8, the economic characteristics are similar, and segments are similar with regard to:

- a. nature of services and products sold;
- b. nature of production processes;
- c. type or class of customers;

- d. methods used to distribute products or provide services; and
- e. nature of regulatory environment.

In some cases, the aggregation characteristics in IFRS 8 are not as relevant to a real estate entity as they would be for other entities outside the industry (for example, the nature of the regulatory environment being similar). In such cases, a real estate entity could still aggregate operating segments, provided that the other criteria that are relevant or meaningful, when applied, are met.

In assessing the areas listed in [paragraph 12 of IFRS 8](#) for a real estate entity, management should consider the relevant attributes of the segments, including the nature of the investment properties and how they are managed, the economic environment of the properties' location, and the different types of tenant.

IFRS 8 requires disclosures of judgements relating to aggregation of segments, specifically the economic indicators that have been assessed to determine that the aggregated segments share similar economic characteristics.

[\[IFRS 8 para 22\]](#).

8.2.7. Future plans in determining reportable segments: abandonment of operations with a view to reinvesting

A real estate entity might sell all of its investment properties that are in one specific location, but have plans to buy another property in the same location in the future.

The entity might continue to report the respective segment, even though it contains no assets. If the CODM continues to review this segment and expects that the absence of assets in this segment will be temporary, management might choose to continue to report a segment in the current period, even though separate reporting of the segment is no longer required. [\[IFRS 8 para 17\]](#).

However, if the purchase of the new property takes more than one year, such that the segment results for all periods presented are zero, management should assess whether continued reporting of this segment provides useful information for users.

8.2.8. Transfers of investment property

A real estate entity might reclassify a property from investment property to inventory, due to the commencement of development with a view to sale. The operating segment which now includes this inventory might not have previously met the quantitative thresholds for separate reporting. If, after reclassification, the operating segment now meets the quantitative thresholds, the entity is required to disclose the operating segment containing inventory as a separate segment, with prior year comparative information.

Note that this does not mean that the entity should restate the comparative information to show the property as inventory in the prior year. The property was investment property in the prior year, and the transfer only affects the current period. Further, the property was not reflected as inventory in the reporting to the CODM in the previous year.

The transfer of one property to another segment is not a change in the internal structure of the entity in a manner that causes the composition of the reportable segments to change. [\[IFRS 8 para 29\]](#).

8.2.9. Change in the manner in which properties are managed

A real estate entity might change the way that it manages its investments for various reasons (for example, due to increasing risk related to property investments in a geographical area). This might require a change in the reporting to the CODM, which will result in a change of the composition of the reportable segments.

If the change in the internal organisation results in a change to the information that the CODM reviews to assess performance of operating segments and allocate resources, the entity will need to change the composition of its operating and reportable segments.

This requires a restatement of prior year segment data, unless this information is not available and the cost to develop the information would be excessive. [\[IFRS 8 para 29\]](#). In the latter case, the entity must disclose that fact and present segment information on both the new and the old basis in the year in which the segment changes occur. [\[IFRS 8 para 30\]](#).

8.2.10. Use of non-IFRS information

An entity should report information using the same measures that are used in the reports regularly provided to the CODM.

If the report to the CODM uses non-IFRS information, the entity is required to use this information for its segment reporting. For example, management in the industry often reviews performance of the business on a 'look-through' basis – that is, it analyses and reviews the performance of not only the portfolio that is directly held but also those held jointly through separate vehicles.

The amount of each segment item reported should be the measure reported to the CODM for the purpose of making decisions about allocating resources to the segment and assessing its performance. [IFRS 8 para 25].

8.2.11. Measurement of reportable segments

An entity should report information on reportable segments as presented to the CODM. Disclosures should be presented to explain:

- the basis of accounting for inter-segment transactions;
- the nature of differences between reportable segments' profit or loss before tax from continuing operations and the reported IFRS profit;
- the nature of differences between reportable segments' assets/liabilities and the assets/liabilities reported in the balance sheet;
- any changes from prior years in measurement methods; and
- the nature/effect of asymmetrical allocations to segments.

[IFRS 8 para 27].

If the CODM uses only one measure to allocate resources and assess performance, and this single measure is based on non-GAAP information, this measure should be used for the purpose of segment reporting. In this case, the explanations of the measurements used (as required by para 27 of IFRS 8) gain additional significance, and a reconciliation of the segments' financial information to the consolidated IFRS financial statements will be necessary. [IFRS 8 para 28].

If the CODM uses both non-IFRS and IFRS-compliant information, the entity should report measures that are determined in accordance with the principles most consistent with those used in measuring the corresponding amounts in the entity's financial statements. For example, if the CODM uses both net profit excluding unrealised fair value gains or losses on investment property and net profit before tax, the latter measure would be more consistent with the profit figures used in the financial statements. [IFRS 8 para 26].

8.2.12. Material items of income and expense to be reported

A real estate entity should disclose several different financial measures if they are reviewed by the CODM when measuring the performance of the segment. [IFRS 8 para 23]. The following are examples of typical financial information that a real estate entity might disclose:

- rental income from external customers;
- interest income;
- interest expenses;
- depreciation and amortisation;
- net gains or losses from fair value adjustments;
- income tax;
- property operating expenses; and
- ground rents paid.

An entity might report items to the CODM on a net basis, although these are recorded on a gross basis in the income statement – for example, the CODM reviews rental income net of rental expenses, but rental income is presented on a gross basis in the income statement. In such cases, the entity should disclose the fact that the amounts are regularly provided to the CODM on a net basis. It should present the amounts of revenue net and then reconcile those to the consolidated IFRS revenue.

A similar example would be where a real estate entity enters into swap agreements to economically hedge the interest rate cash flow risk of variable interest borrowings that finance its property investments.

Example – Presentation of interest income

Background

The information reviewed by the CODM only presents the interest received from the swap, since the entity presents the interest payments on the borrowings, and the interest received and paid from the swap, net.

Solution

Even though the standard requires an entity to report interest income separately from interest expense for each reportable segment, in the above scenario the interest expense should be presented net. This is because the CODM relies primarily on the net interest expense to assess the interest rate cash flow risk. The entity should reconcile the net interest expense to the figures presented in the primary financial statements.

8.2.13. Geographical information

Disclosure of revenue from external customers and certain non-current assets, such as investment properties, is required for the entity's country of domicile, and in total for all other countries. Revenue from external customers and non-current assets attributed to an individual foreign country are disclosed separately, if they are material. Disclosure of revenue by continent would normally not be acceptable. [IFRS 8 para 33].

8.2.14. Major customers disclosure

Entities should disclose the extent to which they rely on major customers. If the revenue of the real estate entity is driven by a single tenant (10% or more of revenue), the entity is required to disclose that fact, and to state the total amount of revenue from that tenant. However, the standard does not require disclosure of the name of the tenant or the property that it relates to. If the revenue is driven by a large number of tenants, and no single tenant or group under common control contributes more than 10% of the entity's revenue, the real estate entity does not need to give this disclosure. However, the entity should state that fact. [IFRS 8 para 34].

8.3. IFRS 13 disclosures

8.3.1. Overview

IFRS 13 requires entities to disclose detailed quantitative and qualitative information about assumptions made and processes used when measuring assets or liabilities at fair value. Further guidance on the measurement requirements of IFRS 13 is contained in section 3.6.

8.3.2. Fair value hierarchy

As noted in section 3.6.5, fair value measurements in IFRS 13 are categorised into a three-level hierarchy. The hierarchy is based on the type of inputs and is defined as follows:

- Level 1 inputs are unadjusted quoted prices in active markets for items identical to the asset being measured. An entity uses that price without adjustment when measuring fair value. A quoted price in an active market is a Level 1 input.
- Level 2 inputs are inputs other than quoted prices in active markets included within Level 1 that are directly or indirectly observable.
- Level 3 inputs are unobservable inputs that are usually determined based on management's assumptions. However, Level 3 inputs have to reflect the assumptions that market participants would use when determining an appropriate price for the asset.
- Fair value measurements of real estate are usually categorised as Level 2 or Level 3 valuations, with Level 3 being the most common categorisation. This is because of:
 - the nature of real estate assets, which are often unique and not traded on a regular basis; and
 - the lack of observable input data for identical assets.

Certain IFRS 13 disclosures are only required for fair value measurements categorised as Level 2 or Level 3. For example, Level 3 disclosures include a description of the valuation techniques used, how decisions are made in relation to valuation procedures and for recurring fair value measurements, the sensitivity of fair value measurements to significant unobservable inputs.

Further guidance on the fair value hierarchy can be found in the [PwC Manual of Accounting chapter 5 paragraphs 88–105](#).

8.3.3. Disclosure of valuation techniques

[Paragraph 93\(d\) of IFRS 13](#) requires the following disclosures for recurring and non-recurring fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy:

- a description of the valuation technique(s) used; and
- the inputs used in the fair value measurements.

Description of the valuation technique

As noted in [section 3.6.4](#), IFRS 13 sets out three valuation techniques:

- the income approach;
- the market approach; and
- the cost approach.

Whilst IFRS 13 does not indicate a preferred valuation technique, the standard requires an entity to choose valuation techniques that are appropriate to the specific circumstances and to maximise the use of observable inputs. An income or market approach will almost always be more suitable to measure fair value for real estate. This is because market participants would usually estimate the price of an investment property based on their expectations about future income. The entity should disclose information on the valuation techniques applied and how it determined that these are the most suitable valuation techniques.

Since IFRS 13 encourages an entity to apply multiple valuation techniques, if appropriate, information should be provided on how it evaluated the fair value out of a range of values.

Inputs used in the valuation technique

For fair value measurements categorised within Level 3 of the fair value hierarchy, an entity should provide quantitative information about the significant unobservable inputs used in the fair value.

The direct capitalisation method and the discounted cash flow method are the most commonly used valuation techniques within the income approach category. These methods are types of present value technique. The fair value is determined on the basis of future income to be earned from the asset. A wide range of quantitative inputs are used in those valuation techniques. Such inputs can generally be grouped into categories, for example:

- income/growth rate;
- yield/discount rate;
- construction and other costs;
- inflation rate;
- capital value; and
- vacancy rate.

8.3.4. Asset classes for disclosure purposes

For the purposes of presenting disclosures, entities are required to determine appropriate classes of asset on the basis of the following:

1. the nature, characteristics and risks of the asset; and
2. the level of the fair value hierarchy in which the fair value measurement is categorised.

[\[IFRS 13 para 94\]](#).

The number of classes is expected to be greater for fair value measurements categorised within Level 3 of the fair value hierarchy, because those measurements have a greater degree of uncertainty and subjectivity. Judgement is required for the determination of appropriate classes of investment property for which disclosures about fair value measurements should be provided.

Companies often disaggregate the classes of properties in accordance with their disclosed segments.

Companies might also disaggregate properties on a basis other than their disclosed segments, usually providing more detail compared to the segment reporting information. Quite often, companies disaggregate disclosures by geography, or class of property, or both.

8.3.5. Sensitivities and sources of estimation uncertainty

Paragraph 93(h) of IFRS 13 requires the following disclosures to be provided for investment properties measured at fair value categorised within Level 3 of the fair value hierarchy:

'... a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, an entity shall also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement. To comply with that disclosure requirement, the narrative description of the sensitivity to changes in unobservable inputs shall include, at a minimum, the unobservable inputs disclosed when complying with (d).'

IFRS 13 requires companies, at a minimum, to include a narrative description of the sensitivity to changes in significant unobservable inputs used in the fair value measurement. The guidance does not explicitly require a quantitative sensitivity analysis. However, such sensitivity analysis might be necessary in order to satisfy the requirements of IAS 1.

Paragraph 125 of IAS 1 requires that *'an entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of: (a) their nature; and (b) their carrying amount as at the end of the reporting period'*.

Where assumptions made in determining the fair value of investment property are significant assumptions in the context of IAS 1, further information should be provided within the financial statements so that users understand the effect of estimation uncertainty. The disclosure of the sensitivity of carrying amounts to significant assumptions is an example of information to be provided in accordance with paragraph 129 of IAS 1. The format of the disclosure might be in a tabular or narrative format.

8.4. Disclosure of fair value for properties accounted for using the cost model

The disclosure of the fair value of investment property accounted for under the cost model is required, except for those properties where the fair value cannot be determined reliably. In such a case, in addition to a description of the investment property, management is required to explain why the fair value cannot be determined reliably and, if possible, the range of estimates within which the fair value is highly likely to lie. [IAS 40 para 78(a)–(c)].

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