

Accounting for real estate – amendment to IAS 40 ‘Investment Property’

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In 2008, the International Accounting Standards Board (IASB) issued a number of amendments to existing International Financial Reporting Standards (IFRSs) as part of its annual improvements project. The annual improvements project provides a vehicle for making non-urgent but necessary amendments to IFRSs.

The Improvements included, among others, an amendment that revised the scope of IAS 40 ‘Investment Property’ to include properties under construction or development for future use as investment properties. This led to a corresponding amendment to the scope of IAS 16 ‘Property, Plant and Equipment’ to exclude such properties. Previously, IAS 16 applied to all properties under construction or development, except those recognised as inventory in accordance with IAS 2, up to the point when construction or development was completed, regardless of the intention for future use as either owner-used property or investment property. Therefore, the decision over the future use of a property must now be made at an earlier stage.

Measurement at fair value

The driver for the amendment was the perceived inconsistency between IAS 40 and IAS 16. It was noted by the IASB that investment property being redeveloped remained in the scope of IAS 40, whereas investment property under construction or development for the first time was excluded and accounted for under IAS 16 until completion of the construction or development. Additionally, the IASB concluded that with increasing experience regarding the use of fair

value as the measurement basis since IAS 40 was issued, entities were more able to reliably measure the fair value of investment property under construction or development.

As a result, properties under construction or development for future use as investment properties must now be measured in the same way as other investment properties recognised by the entity. If the entity measures its investment property portfolio at fair value, investment properties that are under construction or development must also be measured at fair value unless it is not possible to reliably estimate a fair value. In these instances the amended IAS 40 requires these properties to be measured at cost until such time as the fair value becomes reliably measurable or construction or development is completed (whichever comes earlier).

Financial statement disclosures

The amendment, which is effective for accounting periods beginning on or after 1 January 2009, will increase the volatility of the income statement and lead to a number of challenges, not only in determining the fair value (if possible), but also in meeting the disclosure requirements of IAS 40 and IAS 1 ‘Presentation of Financial Statements’. It should be noted that an entity that

chooses to measure its investment properties at cost must also disclose the fair value if it is possible to estimate it.

IAS 40, paragraph 75 (d) states that an entity shall **disclose the methods and significant assumptions applied** in determining the fair value of the investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily based on other factors (which the entity shall disclose) because of the nature or the property and lack of comparable market data.

IAS 1 (R), paragraph 125 states 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 a reporting period, which have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Valuation methodology

Outside of financial reporting, the methodology for valuing development properties is reasonably well established in the UK, although it is primarily used for appraising development opportunities prior to acquisition.

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Asset level transactions involving development properties typically fall into three categories:

- i) Acquisition of land or properties that are not in their highest and best use for development;
- ii) Disposal of completed developments;
- iii) Transactions involving developments in progress. These are rare at the asset (rather than corporate) level and usually occur in either distressed circumstances or during periods of exceptional capital growth.

The latter category, that is developments in progress, is the most challenging from a valuation perspective as there is normally very little, if any, market evidence, other than forced sales.

The lack of transactions and also the site specific nature of development often rules out the use of a market approach for valuation (e.g. comparable sales methodology). Instead, the valuation of development properties is typically based on expected future cash flows and is effectively an income approach.

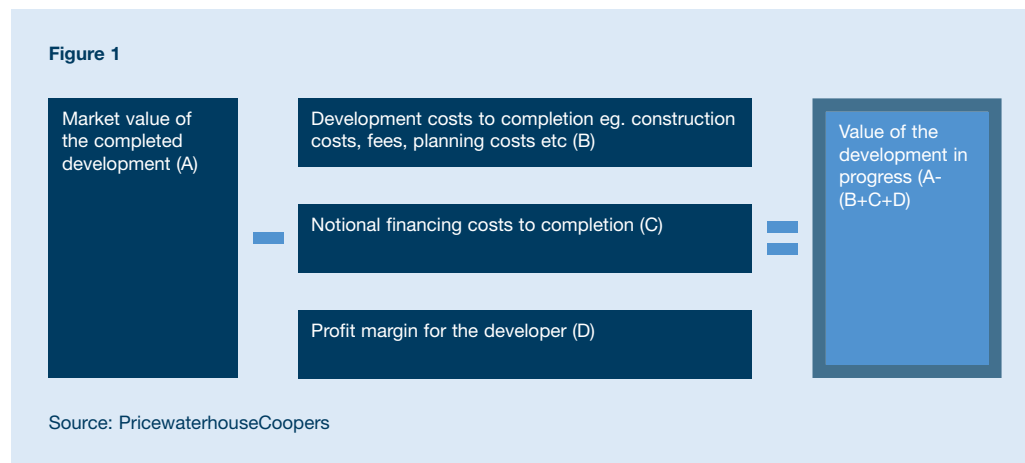
To estimate the future cash flows, the first and perhaps most important step is to identify the optimal development scheme to maximise the value of the site, for example type, scale, specification, etc.

The estimation of the end value and the development costs will then be based upon this conceptual scheme. It is important that the assumptions made regarding the proposed development are realistic and achievable, having regard to the site constraints, planning restrictions, project economics and market demand. Once the construction phase has started the cash flows will nearly always be based upon the actual scheme in progress, unless it clearly fails to deliver optimal value.

The methodology used to value development properties is known as the ‘residual method’, which may be summarised as displayed in Figure 1.

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 ‘traditional 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.

A more robust alternative is to use a discounted cash flow (DCF) methodology to present value as future cash flows. The inputs into DCF methodology will typically be more explicit, both in terms of quantification and timing, than the traditional approach above. The net present value (NPV)



derived from the DCF calculation will represent the current value of the development. The internal rate of return (IRR) will also be visible and provides a helpful sense check, that is the implied return commensurate with the risks involved, having regard to other potential investment opportunities?

Residual method – key valuation inputs

a) Market value of the completed development

Where the property is a commercial development and is intended to be leased to third parties the value of the completed development is normally determined using the methodology applicable to standard investment

properties. However, where the end product is intended to be sold to owner occupiers, for example residential units, a sales comparison approach will usually prove to be a more appropriate methodology. In either case, the methodology for valuing the completed development does not in itself pose new challenges.

The big issue is whether the market value of the completed development should be determined having regard to a) levels of value prevailing at the valuation date or b) the anticipated future exit proceeds, as forecast at the valuation date. Whenever pricing is exhibiting an upward or downward trend, there is likely to be a gap between these two values. At present, valuers in the UK

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typically appear to apply levels of value prevailing at the valuation date. If this approach is followed, the prospects of future value movements prior to completion will need to be addressed through the developer’s profit margin/required return, for example declining values will imply the need for a higher profit margin to cover the adverse market risk.

Larger developments may be phased and for some schemes, for example residential, there may well be partial disposals prior to completion. These credit balances and any rental income received prior to completion need to be reflected and may be more easily incorporated into a DCF approach.

b) Development costs to completion, for example construction costs, fees, planning costs, etc

Development costs to completion exclude sunk costs. The development costs may be actual (i.e. contracted) or estimated if the costs are not yet certain. The costs relate to any project costs needed to complete the development, except for i) finance costs, for example debt, arrangement fees, etc; ii) the developer’s margin; and iii) taxes.

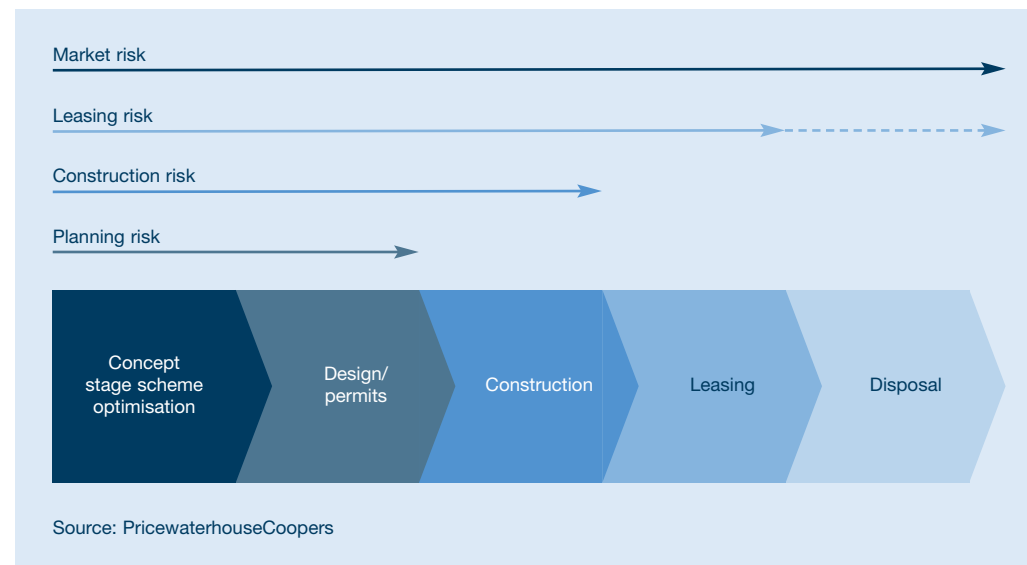
On larger projects, development costs might include, for example, items such as the acquisition of additional plots of land, compensation paid to existing

tenants for obtaining possession or off-site planning gain costs.

c) Financing costs to completion

As mentioned above, the traditional (‘static’) residual appraisal simplifies a number of aspects of the development process. One of the most obvious simplifications is the use of notional rather than actual financing costs. For a ‘static’ residual valuation, the traditional approach assumes that the outstanding development costs will be 100% debt financed with an interest only loan obtained on ‘market terms’, drawn down uniformly over the development period. The interest charge on the notional borrowings is then deducted as part of the static residual calculation. Notional interest costs on the value of the development in progress (i.e. hypothetical purchase price) are also reflected as a purchaser would have holding costs on the capital expended until the development is complete.

The financing assumptions above are clearly divorced from reality as development projects are rarely 100% debt financed and the actual profile of expenditure will typically be loaded towards the second half of the project (an ‘S’ curve profile). In the current market, the reduced availability of debt finance is hard to incorporate into a traditional appraisal.



In practice, the financing of developments is normally a mix of debt and equity, and in a traditional residual valuation the return on equity to the developer is partly captured through the artificial assumption of debt finance on 100% of the costs and partly through the profit margin discussed below. The implied equity return for the developer is not clear from the traditional methodology, although this may be overcome by using a DCF approach.

d) Profit margin for the developer

The profit on development is not realised until an exit occurs, although obviously with phased schemes/disposals,

profits/losses may be crystallised during the development period. Nonetheless, the development profit should start to accrue as the development progresses.

Post-acquisition, a typical commercial development will involve a number of definable steps shown in the diagram above.

As the development passes through these steps it will (in a stable market) become progressively de-risked. If a scheme has been partially de-risked then a hypothetical purchaser should be willing to accept a lower profit margin

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than envisaged at the outset and consequently will be willing to bid more for the property. The rate at which the profit accrues during the development will be judgemental and specific to an individual development, reflecting the relative risks in each step.

In a static appraisal, it is usual to deduct the developer's profit as a lump sum, based upon a percentage of the development costs. When the risks are higher, the required profit margin will increase. With a DCF approach, the required profit margin may be captured in the discount rate and anticipated changes to the quantum and timing of the inputs should be reflected in the cash flows.

While profit will normally accrue as development progresses, there remains a very important overlay, namely, market risk, which impacts on leasing and exit proceeds. In a market with weak occupier demand, the inherent risk (and profit requirement) will remain high until the space has been leased to an occupier(s), even though the front end of the development, that is construction, may be largely complete and de-risked.

Market risk also has a dramatic impact on the future exit proceeds. If the capital value of the completed project is declining, the assumed profit margin/return will be eroded unless the development costs can be scaled back. Consequently, when values are falling, a hypothetical purchaser is likely to require a higher profit margin and will

reduce their bid accordingly. In these circumstances, an alternative might be to postpone an exit until the market recovers. Nevertheless, the ongoing holding costs and uncertainty regarding the future exit proceeds will still have an adverse impact on the current value of the project.

Volatility

The high level of operational gearing inherent in the development process has a direct impact on the residual method and small variations to the inputs will result in a disproportionate change in the end value. This sensitivity will amplify value movements during a real estate cycle and consequently the value of developments in progress may be highly volatile.

Conclusions

The requirement to fair value development projects has coincided with a particularly sharp downturn in real estate markets. Reduced occupier demand, falling rents and yield decompression have resulted in many developments becoming economically unviable.

For developments at the feasibility stage, existing use values might now be higher than the development value and, where

projects have already commenced, there is a risk that the costs to date may be higher than the current fair value.

From a valuation perspective, the inherent sensitivity of the residual methodology needs to be recognised, as does the level of estimation involved. Most development valuations will be less robust than equivalent valuations of income-producing investments. It is therefore important to apply secondary valuation approaches wherever possible. This might involve running traditional 'static' and DCF methodologies side by side or the checking of valuation outputs against observable market prices where available, for example values per acre/hectare for industrial land or a value per square foot of developable area for a city centre office site. When applying the traditional residual approach, the valuer needs to be aware of the simplifying nature of the methodology and check that it does not produce an otherwise unsupportable value.

In terms of financial reporting, in addition to measuring the fair value of the development, entities need to consider the level of disclosure required. Typically, pricing is not observable in the market and so developments are likely to require a relatively high level of disclosure.

Nicholas Croft is a director in PricewaterhouseCoopers' Valuations practice.

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