IAS PLUS

Deloitte & Touche

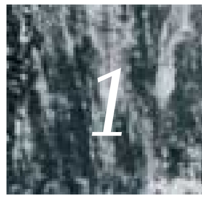
Investment**Property**

The future for UK property accounting under IAS

by **Parizan Trewin**

Contents

Foreword



On first reading IAS 40, it appears to be relatively straightforward, but the implications of applying this standard go deeper. The effects of adoption will affect what can be included as an investment property, how the property is valued, and how changes in value are reported. Its adoption may well start a gentle series of shock waves throughout the financial statements and beyond to the analysts and the markets.

Although I hope that some aspects of IAS 40 will be changed, we need to stop and think about how implementing International Accounting Standards will affect us – 2005 is not that far away. This publication aims to give the reader a glimpse of what lies ahead and an insight into the issues so that they are prepared.

I commend this short Deloitte & Touche publication, and believe you will find it to be a useful starting point in considering the impact of IAS 40 on property accounting and in generating discussion on the issues for UK property companies.

Simon Melliss
Finance Director
Hammerson plc
January 2002

Executive Summary

Impact of IAS 40 on UK property companies

2

Why should I read this?

The European Union has done it again. In their quest to demonstrate their ability to compete with US regulators they have focused on accounting standards and proposed a regulation:

All entities with securities listed within the EU which prepare consolidated accounts for periods beginning on or after 1 January 2005 must apply International Accounting Standards ('IAS').

While the regulation is still in draft and rumours abound that there is pressure to delay it, not only the European Commission, but also the member state governments, all appear to be committed to meeting the 2005 deadline.

This means that affected entities will need to apply IAS in 2004 in order to be able to report comparative figures in 2005.

Even earlier than this, companies will have to run systems in parallel in 2003 in order to ensure that they report the correct figures under UK GAAP in 2003, can be sure that their systems can cope with the requirements of IAS for 2004, and that the changes to the results arising from the new basis are understood by management and analysts.

Property accounting has been affected by many new accounting treatments in the past year – FRS 15 governed what could and could not be capitalised, FRS 19 will have a significant impact on deferred tax accounting, and UITF 28 detailed the treatment of lease incentives. It has been a time of substantial change, yet there is more to come.

Which brings us to the present day. Companies and their management need to plan how they aim to deal with the transition. From systems design to rewriting accounting manuals, training staff to determining policy, there is a multitude of things to think about.

Companies with investment properties will be particularly affected. This booklet contains guidance for property companies on the areas they need to consider when planning to implement the relevant international standard, IAS 40.

Valuations

Best practice will be for valuers to follow International Valuation Standards ('IVS'), as opposed to the RICS Appraisal and Valuation Manual, as stated in the 2001 edition of the IVS.

The time necessary to complete valuations will almost certainly increase, as will costs.

Management and valuers will need to work together to find their way through the maze.

Classification

Most UK property leases are operating rather than finance. This is because UK property leases tend to include upward only rent reviews which give the lessor, rather than the lessee, the substantial upside reward. Under IAS, properties held under operating leases may not be classified as investment property. As a consequence, such leaseholds would be held on a cost basis and would not therefore appear on the balance sheet.

Reporting

Unlike UK GAAP, IAS requires any gain or loss on valuation to be taken to the income statement in the year in which it arises, not to a statement of recognised gains and losses. This will affect earnings, with implications for performance-linked criteria and performance reporting to investors.

This sounds great for properties which increase in value, but not so good for companies owning properties in underperforming sectors. In either case, this requirement will introduce a degree of volatility into the results of property companies not hitherto experienced.

Cost vs fair value

Companies may choose to hold investment properties either at cost or at fair value. However, companies which wish to avoid volatility in their results, and the cost of external valuers, by adopting the cost model should not celebrate too soon. IAS 40 still requires management to determine and disclose the fair value of investment property when the cost model is adopted.

Taxation

Based upon the recent evidence of the Inland Revenue taxing on the basis of true and fair accounts, it is reasonable to suppose that they will review the basis of taxation following the change to IAS. Certainly, under IAS, companies will have to provide in full for deferred taxation on all revalued assets, which is a further change from FRS 19.

4

UK Market: Old Habits Die Hard

Defining an investment property

SSAP 19, first issued in 1981, is strict over the definition of an investment property:

- an interest in land and/or buildings; or where
- development and construction work has been completed; and where
- the interest is held for its investment potential.

Investment property excludes:

- owner-occupied properties; and
- properties let to and occupied by other group companies.

Use of fair values

SSAP 19 is an early example of accounting based on fair values rather than cost. This could be said to be "user-driven" accounting in that fair value of an investment property is more relevant to predicting future cash flows than historical cost.

The Law vs the Renegade

However this use of fair values, and the consequent absence of depreciation in particular, put SSAP 19 at odds with the law.

To depreciate or not to depreciate?

The Act says yes...

'...any fixed asset...should be depreciated'

Whilst SSAP 19 thinks not...

'...current value...is of prime importance'

This disagreement is reconciled in practice by the accepted use of the true and fair override. This use of the override is hardly the purpose for which it was put into the legislation, but has become something of a necessary loophole to enable property companies to report fair value information which users believe achieves more relevant accounting.

Temporary or permanent movements in value?

One further area where the law is out of date is its reference to the recognition of changes in value: permanent falls in value must be charged to the profit and loss account, but temporary falls in value can be ignored.

SSAP 19 states that all changes must be identified and recognised: temporary movements in value, whether up or down, should be reported in the statement of total recognised gains and losses, and stored in the revaluation reserve. However, all permanent impairments should be reflected in the profit and loss account.

Rules vs Practice

Ten of the largest investment property companies all consistently adopt the treatment required by SSAP 19, as demonstrated in the table opposite, although some do not revalue investment properties in the course of construction.

Although there is no requirement to do so, some companies choose to revalue investment properties in the course of development.

On the whole, most companies choose to have all their properties externally valued each year, although there are a fair number which choose to have external valuations performed on a rotational basis with directors' valuations for intervening years. However, where investment properties represent a substantial proportion of the total assets of listed companies, SSAP 19 expects the valuations to be performed by appropriately qualified external valuers at least every five years.

Ten of the largest investment property companies

	Completed investment properties revalued?	Investment properties in the course of construction revalued?	External valuers?	Cycle of reported revaluations	Depreciated?	Profit or loss on sale	Treatment of revaluation surpluses and deficits in line with SSAP 19?
The British Land Company	✔	✘	✔	Every six months	✘	Exceptional item below operating profit	✔
Brixton Estate	✔	✘	✔	Every six months	✘	Exceptional item below operating profit	✔
Canary Wharf Group	✔	✔	✔	Every six months	✘	Exceptional item below operating profit	✔
Chelsfield	✔	Not specified	✔	Annually	✘	Exceptional item below operating profit	✔
Great Portland Estates	✔	✔	✔	Every six months	✘	Exceptional item below operating profit	✔
Grosvenor	✔	✘	✔	Annually	✘	Exceptional item below operating profit	✔
Hammerson	✔	✔	✔	Every six months	✘	Exceptional item below operating profit	✔
Land Securities	✔	✔	✔	Every six months	✘	Exceptional item below operating profit	✔
Liberty International Holdings	✔	✘	✔	Every six months	✘	Exceptional item below operating profit	✔
Slough Estates	✔	✘	✔	Every six months	✘	Exceptional item below operating profit	✔

Source: latest annual and interim reports.

International Market

6

New boy in town – IAS 40

On the international scene, fair value has formed the basis of accounting in three recent standards, derivatives in IAS 39, investment properties in IAS 40, and agricultural livestock and produce in IAS 41. IAS 40 became effective for 2001 calendar years. Prior to IAS 40, investment property was accounted for under the general tangible fixed asset standard IAS 16, *Property, Plant and Equipment*. Alternatively, a treatment similar to SSAP 19 was possible by dealing with investment properties under the investment standard, IAS 25. However, the International Accounting Standards Board ('IASB') believed that the characteristics of investment property were sufficiently different from owner-occupied property. Thus IAS 40 was created and the definitions and choice of models are discussed here.

The detailed definition of what comprises investment property under IAS 40 appears in the table opposite. Property which was previously classified as investment property under SSAP 19 will generally also be classified as investment property under IAS 40 with one major exception. Property held under an operating lease by a lessee is not investment property under IAS 40 – the lease falls under the remit of the international standard on leases and therefore the property may not be held on the balance sheet.

Initial measurement

Investment properties are initially measured at cost. Cost includes any directly attributable expenditure:

- legal fees;
- property transfer taxes.

Cost does not include:

- 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;
- abnormal amounts of wasted resources, such as labour and materials, incurred in constructing or developing the property.

After initial measurement?

Two options are available:

- fair value model; or
- cost model.

The model chosen by management should be applied to all investment properties.

Whichever model is chosen, management is required to determine the fair value of investment property, as the fair value needs to be disclosed if the cost model is adopted.

Independent valuation of fair value?

Management is encouraged, but not required, to determine the fair value of investment property on the basis of a valuation by an independent valuer:

- who holds a recognised and relevant professional qualification; and
- who has recent experience in the location and category of the investment property being valued.

What is an investment property?

	Under IAS 40	Under SSAP 19
Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business	✔	✔
Land held for a currently undetermined future use	✔	✔
A building owned and leased out under one or more operating leases	✔	✔
A vacant building held to be leased out under one or more operating leases	✔	✔
Investment property being redeveloped for future use as investment property	✔	✔
Property held under an operating lease by a lessee	✘	✔
Property held for sale in the ordinary course of business or in the process of construction or development for sale	✘	✘
Property being constructed or developed on behalf of third parties	✘	✘
Owner-occupied property, including property intended to be used as owner-occupied property	✘	✘
Property that is being constructed or developed for future use as investment property – this is a development property until construction or development is complete, at which time the property becomes investment property	✘	✘

Fair value model

Fair value is defined as:

'The amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction'.

The components of the definition are discussed in the table below.

Key features of the fair value model

If management chooses to adopt the fair value model:

- all investment property should be measured at its fair value;
- a gain or loss arising from a change in the fair value of investment property should be reported in the income statement, and included in net profit or loss for the period in which it arises.

What does the definition of fair value mean?

Knowledgeable	Both parties are reasonably informed about: • the nature and characteristics of the investment property • actual and potential uses of the investment property • the state of the market as of the balance sheet date
Willing buyer	Will take the state of the current market into account
Willing seller	Motivated to sell the investment property at market terms for the best price obtainable in the open market, i.e. an adequate number of potential purchasers should have been made aware that the investment property was for sale
Arm's length transaction	A transaction between parties who do not have a particular or special relationship that makes the transactions uncharacteristic of the market

Evidence of fair value

Current prices on an active market for properties of a different nature, condition or location, adjusted to reflect those differences

Recent prices on less active markets, adjusted to reflect any relevant changes in economic conditions

Discounted cash flow projections based on reliable estimates of future cash flows using:

- terms of existing leases or other contracts
- current market rents for similar properties in the same location and condition
- discount rates that reflect current market assessments of the uncertainty and timing of the cash flows

Current application

IAS 40 states that all valuation movements should go through the income statement, but there is no final guidance on what the income statement will look like under IAS. There are two ways to address the reporting issue:

1. Shoehorn the revaluation into the income statement.
2. Revert to the cost basis in the statutory accounts and provide supplementary information on whatever basis you feel is most useful and/or relevant.

Reporting

The latest available results of ten of the largest investment property companies have been aggregated in the table below. The effect of applying IAS 40 to the aggregated results has increased the aggregated retained profit by 270%, even after fully providing for deferred tax on the revaluation gain as required under IAS. This is clearly a significant change to the way that users of the accounts will receive and interpret information.

Aggregated results for ten of the largest investment property companies	**£m**
Gross rental income	2,372.4
Less: share of joint ventures' turnover	(120.9)
Net operating costs	(528.8)
Operating profit	1,722.7
Share of operating profit in joint ventures and associates	98.7
Profit on disposal of investment properties	76.5
Net interest payable	(815.0)
Exceptional items	(30.4)
Profit on ordinary activities before taxation	1,052.5
Taxation	(177.5)
Profit on ordinary activities after taxation	875.0
Minority interests	(25.7)
Profit for the financial year	849.3
Dividends paid	(392.5)
Retained profit under UK GAAP	**456.8**
Retained profit under UK GAAP	**456.8**
Revaluation gain	1,763.4
Less: deferred tax on revaluation gain at 30%	(529.0)
Retained profit after applying IAS	**1,691.2**
Increase on IAS retained profit compared with UK GAAP	**270%**

Source: aggregation of profit and loss accounts from latest available annual reports for companies listed on page 5.

The second option was virtually forced upon Hongkong Land Holdings as 90% of their property portfolio comprises leasehold property and so does not meet the definition of investment property under IAS 40. Hongkong Land decided to present supplementary information where the figures were prepared in accordance with IAS with the exception that movements in the fair value of leasehold properties were reflected in the profit and loss account.

Cost model with supplementary information

Hongkong Land Holdings Limited

Year ended 31 December 2000

Consolidated Profit and Loss Account	**IAS basis**	**IAS modified basis ***
	US$m	**US$m**
Revenue	386.5	386.5
Recoverable and non-recoverable costs	(97.1)	(77.2)
Net income from properties	289.4	309.3
Other income	1.2	1.2
Administrative and other expenses	(27.5)	(27.5)
	263.1	283.0
Fair value gain of investment properties	**–**	**2,022.4**
Asset impairment (provisions)/reversals and disposals	125.0	(9.8)
Operating profit	388.1	2,295.6
Net financing charges	(41.1)	(41.1)
Share of results of associates and joint ventures	13.4	16.6
Profit before tax	360.4	2,271.1
Tax	(27.0)	(26.7)
Profit after tax	333.4	2,244.4
Minority interests	(0.1)	(0.1)
Net profit	333.3	2,244.3

Net profit for the period is therefore US$1.9billion higher on the modified IAS basis than under the normal IAS basis, which is an increase of 573%.

Source: latest available annual report.

Issues Facing UK Property Companies

10

There are a number of major issues which UK property companies will need to address in the change to IAS 40. The major issues are covered here.

Reporting

All gains and losses on valuation must be presented in the income statement, although it is not precisely defined where in the income statement those gains or losses should be shown.

In addition, IAS requires the gain on initial valuation of an investment property which was constructed by the owner to be included within income.

One consequence will be that any performance criteria (e.g. for share options or executive remuneration) which are linked to reported earnings will need to be re-evaluated.

Management will also need consider the impact of IAS 40 on performance reporting to investors – changes in earnings will need to be communicated and explained to shareholders.

Leases

Under the current IAS definition, properties held under operating leases are excluded from investment property. This is a potentially huge problem as a large number of UK property leases are currently treated as operating leases.

Under IAS, companies will have to account for these properties as operating leases under the IAS leases standard, which is similar to SSAP 21.

Valuations

IVS will represent best practice in the valuation profession. IVS should therefore be followed by the valuers when revaluing investment property as opposed to the RICS Appraisal and Valuation Manual (the 'Red Book') which is used by all UK external valuers at the moment. IVS are still being revised and updated by the International Valuation Standards Committee ('IVSC') which has the objective, by 2002, of publishing "a set of comprehensive and robust international standards, covering all major areas of business" *(foreword to IVS 2001)*. The chairman of the IVSC has stated that it continues to work closely with its sister organisation, the IASB.

Chartered Surveyors and management will need to work together to evaluate how different these standards are and assess the impact of using them to value investment property.

Taxation

With gains or losses on valuation going through the income statement, as opposed to the statement of total recognised gains and losses and the revaluation reserve, and based upon the recent trend of the Inland Revenue to tax on the basis of true and fair accounts, it is reasonable to suppose that they will review the basis of taxation following the change to IAS. At the very least, under IAS, companies will have to provide in full for deferred taxation on all revalued assets.

Moving targets

The IASB are still actively working on standards. Of particular relevance is the development of a new standard which will replace the income statement with a combined performance statement. Companies need to be sure that they are aware of the latest requirements.

Deloitte & Touche, through monitoring of IASB activity, are well placed to be aware of developments as, and when, they happen. All relevant developments are reported on the IASB website: http:\\www.iasb.org.uk and our website: http:\\www.iasplus.com which seeks to expand and interpret IAS 40.

Who to Contact

12

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Deloitte & Touche would be pleased to advise on specific application of the principles set out in this publication. Professional advice should be obtained as this general publication cannot be relied upon to cover specific situations; application will depend upon the particular circumstances involved.

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