Accounting for investment property under construction - a practical guide

Ernst & Young
Quality In Everything We Do

1 General

1.1 Introduction[1]

In 2006, the International Financial Reporting Interpretation Committee (IFRIC) considered the question of whether the revaluation option in IAS 16 *Property, Plant and Equipment* was available for investment property under construction (IPUC). At that time, the IFRIC noted that since IAS 40 *Investment Property* had been written, the use of fair values in accounting had become more widespread and valuation techniques were becoming more robust.

In light of these developments, the IFRIC decided that the requirement that IPUC be accounted for under IAS 16 may no longer be necessary and referred the issue to the International Accounting Standards Board (IASB). The IASB noted that:

- Investment property (IP) being redeveloped remained within the scope of IAS 40, and that the exclusion of IPUC gave rise to a perceived inconsistency.
- With increasing experience of the use of fair value since the issue of IAS 40, entities were finding it easier to obtain a reliable measure of the fair value of IPUC.

Consequently, the IASB, as part of its annual improvement process, in May 2008, approved changes that brought IPUC into the scope of IAS 40 for annual periods beginning on or after 1 January 2009.

As a result, for such periods, entities reporting under IFRS must re-classify IPUC from IAS 16 to IAS 40. This means that any entities who wish to measure their completed IP at fair value – and our 2009 survey[2] of real estate companies found that this is dominant practice – must also measure their IPUC at fair value.

Even if an entity measured its IP using the cost model (the other measurement option available in IAS 40), it would still need to obtain the fair value of the IPUC since IAS 40 requires disclosure of the fair value of all IP.

However, the concern remains that, in some situations, the fair value of IPUC cannot be determined reliably. Therefore, the IASB concluded that for those entities that chose the fair value model for completed IP, it would allow IPUC to be measured at cost if fair value cannot be determined reliably until such time as the fair value becomes reliably determinable or

Revised model for accounting for investment property

Accounting policy adopted for IP	Completed IP and IP under redevelopment	IP under construction
Cost	Cost in accordance with historical cost model as under IAS 16	Cost in accordance with historical cost model as under IAS 16
Fair value	Fair value with changes in fair value through the income statement	Fair value with changes in fair value through the income statement unless fair value not reliably determinable in which case it is accounted for at cost in accorance with IAS 16, until either its fair value becomes reliably determinable or construction is completed (whichever comes earlier) after which it is measured at fair value with changes in fair value through the income statement

[1] *With permission from the European Public Real Estate Association (EPRA), extracts of the EPRA paper, "Valuing Investment Property under Construction, EPRA Recommendations to IVSC", have been included in this publication.*

[2] *IFRS for real estate – current issues and financial statements survey, February 2009.*

construction is completed (whichever comes earlier).[3]

Entities may apply these changes prospectively for annual periods beginning on or after 1 January 2009. An entity is also permitted to apply the amendments to IPUC from any date before 1 January 2009 provided that the fair values of IPUC were determined at those dates.

This publication is intended to assist you in assessing the implications of the amendments to IAS 40 for the financial statements of real estate companies under IFRS.

The table on page 2 provides an overview of the revised model for accounting for IP.

2 Valuation guidance and principles

2.1 Existing guidance

A lack of current (or recent) transaction prices of similar properties under construction usually requires the use of estimation models. IAS 40 does not contain any specific guidance as to the valuation of IPUC and reference is often made to International Valuation Standards (IVS), but until recently the extent of IVS guidance in this area was limited. Looking further, in the UK, The Royal Institution of Chartered Surveyors (RICS) has in issue *Valuation Information Paper 12 — Valuation of Development Land*, but this does not specifically relate to land that is actually in the course of development, although the principles are similar.

So, whilst the valuation of IPUC is complex and judgmental, there is a need for more detailed guidance on the subject. Common methods found include: (i) the hypothetical developer's method otherwise known as the 'residual method' of valuation; and (ii) the discounted cash flow (DCF) method.

The hypothetical developer's method deducts costs of construction, finance and anticipated profit (a percentage of cost) from an exit value i.e., the gross development value of the completed project. The DCF approach uses (project) risk adjusted discount factors. A further explanation of these methods is included in the Appendix.

Both the European Public Real Estate Association (EPRA) and the International Valuation Standards Board (IVSB)[4] have recently released more detailed guidance to assist (and improve consistency amongst) preparers of financial statements, valuers, advisers and investors. Below we discuss the guidance issued by both of these bodies (remainder of this section) and the possible accounting implications (section 3). In addition, we provide illustrative disclosures for IPUC in the financial statements (section 4).

2.2 EPRA guidance — the framework[5]

As properties are rarely, if ever, identical, a comparison with the observed market prices in other property transactions can only be used as a guide to fair value; valuation models are needed. However, a model that determines the fair value of IPUC will inevitably be more complex and judgmental because:

- There is a much less active market for IPUC than for completed investment property. Where IPUC is transacted, this is typically when it is in the very early stages of development, or when it is nearly complete and substantially let.
- Additional assumptions must be made about the risks and costs of any incomplete construction.

One of the key judgments in a model to estimate the fair value of IPUC is when to recognise any gain over the cost of the development. In some circumstances, the development process may not realise a project gain. Project values may decrease during the development process due to factors such as : (i) economic circumstances, changes in market conditions or changes in occupier fundamentals reducing the projected value of the completed property; and/or (ii) development costs exceeding budgets/ forecasts. The principles set out below assume that a project gain will be achieved. Although the EPRA paper did not address situations in which project losses arise even if IPUC is measured at cost, both IAS 40 and IAS 36 require an impairment test to be performed if there are indicators of impairment.

2.3 The EPRA principles

The valuation principles agreed by EPRA members are:

- The starting point for any valuation of IPUC should be a completed property. Such a valuation should be based on current valuations applicable to similar existing completed properties with comparable encumbrances to property rights. In practice, property is not usually fully let on completion, but an appraiser will still be able to value the IPUC and should normally be able to demonstrate possible scenarios.

[3] *IAS 40 paragraph 53 as amended.*
[4] *The IVSB is the independent standard-setting body of the International Valuation Standards Council (IVSC).*
[5] *Refer to "Valuing Investment Property under Construction, EPRA Recommendations to the IVSC", November 2008.*

- The gain which may be attributable to realising project objectives is the difference between the value of a completed building and its construction costs - including the cost of the land, finance costs incurred during construction and any directly attributable costs.
- Project risks relate to risks associated with realising the project objectives. The existence of unmitigated project risks can impact the quantum of the project gain to be recognised, if any. The significant project risks associated with the development should be identified.
- When project risks are minimised or eliminated, some project gain may have been achieved and the value of the project increased. However, the project gain should only be recognised in a valuation of an IPUC when a substantial amount of the project risks have been reduced or eliminated. An appraiser should disclose the significant judgments used in determining the stage at which a substantial amount of the project's risks have been eliminated.
- Notwithstanding the above, if the land has increased in value, for example, via the issue of government permits and this is corroborated by comparable prices for land in that condition in an active market, then that part of the project gain should be recognised.
- Valuations should be based on project cash inflows and outflows, taking into account the time value of money and remaining project risks. The cash outflows must include all construction and other project costs still to come, based on contracted terms and current best estimates.
- The transparency of the valuation estimate is important. Appraisers should include a description of their valuation methodology and the key assumptions used in their report to the client. In particular, the appraiser must also identify how the remaining risks of the project have been dealt with in the valuation. Any contingent element, deductions or risk adjusted discount rates, should be quantified and explained with reference to the remaining project risks.

2.4 The IVSB guidance

The IVSB published guidance for valuation of IPUC in its Exposure Draft on the Proposed Guidance Note August 2009.[6]

The IVSB principles are substantially consistent with EPRA, with the exception that IVSB does not specifically caution against the recognition of a development gain until the project risks are substantially eliminated. Paragraph 3.8 of the Exposure Draft on the Proposed Guidance Note states that:

"Allowance should be made for the return that would be required by a buyer of the partially completed investment project in the market place. This should reflect the risks associated with the completion of the construction programme and in achieving the anticipated income or capital appreciation on the date of valuation."

Paragraph 3.7 further explains that:

"All significant risks should be identified and evaluated. Typical risks associated with any partly completed construction project will include variations in construction cost, finance costs and the construction programme. Additional risks associated

[6] *IVSB Exposure Draft on Proposed Guidance Note: The Valuation of Investment Property under Construction, August 2009.*

with investment property under construction include fluctuations in the value of the completed project between inception and completion, and the time that will be required to secure lessees and a stabilised income. The risks associated with generating income from the property after completion should be identified and evaluated separately from the risks associated with completing construction. If the valuation inputs are based on current values and costs, the risk of movement between the valuation date and the anticipated completion date should be evaluated. If prospective values and costs have been used, the risk of those projections proving to be inaccurate should be evaluated."

3 Implementing the new requirements

Below, we consider a number of practical questions that the adoption of the amendment to IAS 40 for IPUC may raise:

Is completed IP presented on the same line as IPUC on the face of the balance sheet?
IPUC can be presented as part of total IP on the face of the balance sheet. However, an entity may also wish to show completed IP and IPUC as separate items within that total on the balance sheet or in the notes to the balance sheet. We consider it best practice to, at a minimum, provide separate information on IPUC and completed IP in the notes to the balance sheet as both categories are generally subject to a different set of assumptions and accounting estimates. Moreover, IFRS also requires separate presentation of IP (including IPUC) at cost (where fair value cannot yet be reliably measured) and IP (including IPUC) at fair value.

Is any difference between cost and fair value at the beginning of the period in which the amendment is adopted (that results from the implementation of IAS 40 for IPUC) recognised in the income statement or in equity?
The recognition of the cumulative adjustment in the income statement in the period of adoption of the amendment would seem to be the most appropriate approach. However, the drafting of the transitional provisions of IAS 40 would also seem to allow recognition of the cumulative adjustment in equity at the beginning of the period of adoption.

When can fair value for IPUC be reliably determined?
This is a matter of judgment and, in principle, it is management (perhaps on the advice of an external valuer)[7] that needs to express an opinion on reliability. In section 2.3, we noted that EPRA advises caution against recognising a development gain until a substantial part of the project risk has been reduced or eliminated. However, EPRA does not provide guidelines as to which criteria should be applied. Indicators that we believe may be used to assess whether the substantial risks are eliminated might include:[8]

- All required building and letting permits have been obtained.
- Development costs can be reliably estimated. This may be the case when a fixed price construction contract with the main contractor is agreed.
- The value of the completed property can be reliably estimated. This may be the case when a substantial proportion of the rentable area has been leased to tenants.

Other indicators may also be appropriate in light of the facts and circumstances of individual developments.

It is worth noting that the IVSB stated in their Interim Position Statement of January 2009 that "IPUC should be capable of reliable determination in all cases where there is sufficient comparable market data available to undertake a valuation." In the Exposure Draft on the Proposed Guidance Note, the IVSB, however, proposes in question 5 "that it is outside the scope of this guidance note to consider whether a valuation can be reliably determined for the purpose of IAS 40" and explicitly leaves the concept of reliability "with entities and their advisors who interpret IFRS."[9] The EPRA principles recommend a prudent approach to recognising development gain, rather than explicitly setting out when a fair value cannot be determined.

According to the IVSB, it is important that all project risks have been identified, evaluated and quantified. Based on these identified risks and the assessment of sufficient comparable market data, the valuer normally determines the adjustment needed to reflect project risks.

In any event, any IPUC carried at cost is still subject to the impairment provisions of IAS 36. IAS 36 requires a recoverable amount to be determined as the higher of: (i) value in use; or (ii) fair value less costs to sell. Even if fair value is considered unreliable, a value-in-use calculation must be performed, which is a discounted future cash flow analysis. If such a discounted future cash flow must be prepared for IAS 36 purposes, it may not be that difficult to change entity specific assumptions into market specific assumptions.

[7] *External appraisals are recommended but not mandatory.*
[8] *Illustrative suggestions only.*
[9] *IVSB Exposure Draft on Proposed Guidance Note: The Valuation of Investment Property under Construction, August 2009, question 5 for respondents.*

Consequently, there is likely to be an ongoing debate as to when IAS 40 paragraph 48 and 53 can, under certain circumstances, be applicable, or whether it would be extremely rare for the fair value of IPUC not to be capable of reliable determination.[10]

If an entity held IPUC using the revaluation option in IAS 16, how should the revaluation reserve in equity be dealt with?
In the period of adoption of the amendment, it is appropriate for the revaluation reserve to be transferred to retained earnings directly within equity.[11] It should not be recycled through the income statement.

What does this mean for the accounting principles the entity adopts and discloses, and for the notes to the balance sheet?
Accounting policy notes will need to be revised and the impact of adoption of the amendment should be disclosed. Chapter 4 provides practical guidance for real estate companies that adopt this amendment to IAS 40.

If the fair value of IPUC cannot be reliably determined, which additional disclosures have to be provided?
IAS 40 paragraph 78 requires the following disclosures:

- A description of the IP
- An explanation of why fair value cannot be determined reliably
- If possible, the range of estimates within which fair value is highly likely to lie

Must the additional disclosures referred to in the question above be provided for each property or per group of properties?
If the fair value of IPUC cannot be reliably determined, paragraph 78 of IAS 40 makes reference to disclosures on "that investment property". Accordingly, we believe this additional disclosure should be provided for each IPUC where the fair value cannot be measured on a reliable basis.
It would usually be appropriate for individually immaterial IPUC to be combined and disclosure provided on an aggregate basis.

Does IAS 40 require additional disclosure for IPUC to be provided in interim financial statements?
Paragraph 16 of IAS 34 requires, as a minimum, the disclosure of the effect of changes in estimates of the amounts reported previously. Therefore, we consider it best practice to disclose the significant assumptions and estimates applied in determining the fair value of IPUC in interim financial statements.

[10] *IAS 40 paragraph 48 states that it may be the case that fair value cannot be estimated reliably if the variability in the range of reasonable fair value estimates will be so great, and the probabilities of the various outcomes so difficult to assess, that the usefulness of a single estimate of fair value is negated. Paragraph 53 states that this arises when, and only when, comparable market transactions are infrequent and alternative reliable estimates of fair value (e.g., based on DCF projections) are not available.*

[11] *Local capital maintenance rules and restrictions on dividends may still require maintaining a legal or revaluation reserve at least in the company-only financial statements.*

4 Accounting principles and notes to the balance sheet

4.1 Introduction

First-time adoption of the amendment to IAS 40 requires careful consideration of the disclosures in respect of changes in accounting policies, the accounting policies themselves and the notes to the balance sheet. The following sections of the financial statements are affected:

- Explanation of changes in accounting policies
- Disclosure of estimates and assumptions
- Accounting policy notes
- Notes to the balance sheet

Illustrative examples of these disclosures are set out below. The example is for a fictitious entity with a 31 December 2009 year-end that previously held investment property under construction (IPUC) at cost under IAS 16 and uses the fair value option in IAS 40. These disclosures may not be appropriate for entities that previously measured IPUC using the revaluation option in IAS 16 or those that use the cost option in IAS 40.

The illustrative examples in sections 4.2 and 4.3 only include certain disclosures relevant to this amendment to IAS 40. Other disclosures may be required to fully comply with IFRS.

4.2 Illustrative IPUC accounting principles

4.2.1 Changes in accounting policies and new IFRS standards effective for the year[12]

The company has adopted the following amendments to IFRS in these financial statements:

The amendment to IAS 40 *Investment Property*

Investment property under construction for future use as investment property will also be measured at fair value with changes in fair value being recognised in the income statement when fair value can be determined reliably. However, where fair value is not reliably determinable, the property is measured at cost until the earlier of the date construction is completed and the date at which fair value becomes reliably determinable. As a result of the adoption of the amendment to IAS 40, as at 1 January 2009 the company has reclassified investment properties under construction from "investment property under construction" to "investment properties", at an amount of €1 million, which represents the cost as at 31 December 2008. A fair value increase of €0.18 million in respect of IPUC has been recognised in the income statement in the period to 31 December 2009.[13]

4.2.2 Estimates and assumptions[14]

General

There are a number of key assumptions concerning the future and other potential sources of estimation uncertainty at the balance-sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. These are discussed below:

Revaluation of investment property and of investment property under construction

Investment property includes: (i) completed investment property; and (ii) investment property under construction. Completed investment property comprises real estate (land or building, or both) held by the company or leased under a finance lease in order to earn rentals or for capital appreciation, or both, rather than for use in the production or supply of goods or services, or for administrative purposes, or in the ordinary course of business.

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12 *IAS 8 paragraph 14.*

13 *IAS 8 paragraph 29.*

14 *IAS 1 paragraph 122 states "An entity shall disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements."*

15 *Disclosure of the methodology used will assist stakeholders in understanding the financial statements.*

In this financial period, the company has adopted the amendments to IAS 40. Consequently, investment property under construction is valued at fair value if it can be reliably determined. If a fair value cannot be reliably determined, then investment property under construction is measured at cost. The fair value of investment property under construction is either determined on the basis of the discounted cash flow or the residual methods.[15] However, using either method to value IPUC also requires considering the significant risks which are relevant to the development process, including but not limited to construction and letting risks.

The key judgments and assumptions used for valuing investment property and investment property under construction are set out in note X.[16]

4.2.3 Investment properties under construction

As set out in the description of new accounting standards effective in this accounting period, from 1 January 2009, investment property under construction is measured at fair value (subject to fair value being reliably determinable). When assessing whether the fair value of investment property under construction can be determined reliably the company considers, among other things:

1. Is the asset is being constructed in a developed liquid market?
2. Has a construction contract with the contractor been signed?
3. Are the required building and letting permits obtained?
4. What percentage of rentable area has been pre-leased to tenants?

Investment property under construction for which fair value cannot be determined reliably, is measured at cost less impairment.

The fair values of IPUC were determined at the end of the reporting period based on the opinion of a qualified independent valuer[17] and valuations were performed in accordance with RICS and IVSC Valuation Standards using either the residual method approach or discounted cash flow approach, as deemed appropriate by the valuator. Each investment property under construction is individually assessed.

The estimated value of future assets is based on the expected future income from the project, using risk adjusted yields[18] that are higher than the current yields of similar completed property. The remaining expected costs of completion plus margin are deducted from the estimated future assets value.

15 *Disclosure of the methodology used will assist stakeholders in understanding the financial statements.*
16 *See section 4.3.2(E).*
17 *Disclosure of the use of internal valuations is required under IAS 40, paragraph 75e.*
18 *Or indicate other methods used to account for remaining project risks. See sections 2.3.4 and 2.4.*

4.3 Illustrative notes to the balance sheet[19]

4.3.1 Investment property under construction (under IAS 16)

Until 2009, real estate under construction related to the development of investment properties. Movements are as follows:

	2009 €	2008 €
Balance at 1 January	1,000,000	800,000
Less transfers to investment property	(1,000,000)	–
Additional costs in the period	–	100,000
New developments during year	–	100,000
Balance at 31 December	**–**	**1,000,000**

The Company has adopted the amendment to IAS 40, as described in Note X[20], which brings property under construction within the scope of IAS 40 *Investment Properties*. Consequently, as at 1 January 2009, all investment properties under construction were transferred to investment properties.

4.3.2 Investment properties

A. General

As of 1 January 2009, investment properties owned by the Company include office and commercial space and comprise both completed investment properties and investment properties under construction. As at 31 December 2008, investment properties under construction were presented at cost under 'Investment property under construction'.

B. Movements in the year

Analysed by operating segments as:

	2009			2008		
	Completed investment property €	Investment property under construction €	Total €	Completed investment property €	Investment property under construction* €	Total €
Balance at 1 January	2,100,000	–	2,100,000	2,000,000	–	2,000,000
Acquisition of properties	–	–	–	150,000	–	150,000
Transfers from property, plant and equipment*	–	1,000,000	1,000,000	–	–	–
Subsequent expenditure	–	404,000	404,000	50,000	–	50,000
Adjustment to fair value	60,000	180,000	240,000	100,000	–	100,000
Disposals	–	–	–	(200,000)	–	(200,000)
Balance at 31 December	**2,160,000**	**1,584,000**	**3,744,000**	**2,100,000**	**–**	**2,100,000**

19 *The notes to the balance sheet illustrated here cover completed IP and IPUC.*

20 *See section 4.2.1.*

Comprised of:

	2009			2008		
	Offices €	Retail and mixed use €	Total €	Offices €	Retail and mixed use €	Total €
Completed investment property	1,000,000	1,160,000	2,160,000	970,000	1,130,000	2,100,000
Investment property under construction	704,000	880,000	1,584,000	*	*	*
Balance at 31 December	**1,704,000**	**2,040,000**	**3,744,000**	**970,000**	**1,130,000**	**2,100,000**

* Previously classified as property, plant and equipment (see note 4.3.1).

C. Fair value adjustments

Fair value adjustments comprise:

	2009 €	* 2008 €
Adjustment to fair value of completed properties	60,000	100,000
Adjustment from cost to fair value for investment property under construction at date of transfer to investment property	90,000	–
Adjustment to fair value of investment property under construction arising in the period	90,000	–
Total fair value adjustments for the year	**240,000**	**100,000**

D. Breakdown of investment property

Investment properties can be analysed as follows:

	2009 €	* 2008 €
Completed investment properties	2,160,000	2,100,000
Investment properties under construction at fair value	1,484,000	–
Investment properties under construction at cost[21]	100,000	–
	3,744,000	**2,100,000**

* As at 31 December 2008, investment properties under construction were carried at cost less impairment and are presented as investment property under construction (*see Note under 4.3.2*).

Certain investment properties under construction are carried at cost as management believes that due to the nature and amount of remaining project risks, its fair value cannot be reliably determined.[22] For further details, see Note G.

[21] *Disclosure required under IAS 40 paragraph 78.*
[22] *See IAS 40 paragraph 78b.*

E. Significant assumptions

Significant assumptions[23] (on the basis of weighted averages) used in the valuations as of 31 December are presented below:

	Offices		Retail and mixed use	
	2009	2008	2009	2008
Completed investment property				
Average rental rate per sqm per month (in €)	24	26	33	35
Reversionary yield	7%	6%	6.5%	6.25%
Estimated rental value per sqm per month (in €)	22	27	30	36
Vacancy	9%	5%	5%	3%
Investment property under construction (at fair value)				
Average risk adjusted yield used in capitalising the net future income stream	11%	n/a*	8%	*n/a
Average % complete	56%	n/a	66%	n/a
Estimated average development profit (1-(Total expected costs/Fair value upon completion))	22%	n/a	25%	n/a
Effective average development profit (1-(Total costs spend to date/Current fair value of project at current state))	9%	n/a	18%	n/a

* As at 31 December 2008, investment properties under construction were carried at cost less impairment.

23 *To determine whether an assumption is significant is a matter of judgment. IAS 40 paragraph 75d does not provide specific guidance. These are meant to be illustrative examples only.*

F. Sensitivity analysis

The table below presents the sensitivity of profit (loss) before tax due to change in assumptions. The sensitivities presented are unfavourable movements.[24] If the sensitivity variables were favourable, the positive impact on profit would be of a similar magnitude:

	Offices		Retail and mixed use	
	2009	2008	2009	2008
	€	€	€	€
Completed investment properties				
Increase of 25 bp in reversionary yield	(34,483)	(38,800)	(42,963)	(43,462)
Decrease of 5% in estimated rental income	(50,000)	(48,500)	(58,000)	(56,500)
Investment property under construction*				
Increase of 25 bp in yield	(18,348)	n/a	(30,345)	n/a
Increase of 5% in total construction costs	(32,200)	n/a	(33,000)	n/a
Decrease of 5% in estimated rental income	(41,282)	n/a	(44,000)	n/a
Decrease of 1% in estimated development profit	(10,451)	n/a	(11,579)	n/a

* Excluding investment property carried at cost.

[24] *Although there are no specific guidelines for disclosures in relation to IP, IAS 1 paragraph 129 states that sensitivity analysis should be meaningful and that it should assist users to understand the judgment management makes about the future and about key sources of estimation uncertainty. It also states:*
"The nature and extent of the information provided vary according to the nature of the assumption and other circumstances. Examples of the types of disclosures an entity makes are:
(a) The nature of the assumption or other estimation uncertainty;
(b) The sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
(c) The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
(d) An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved."

G. Additional information[25]

Segment	Property	Value (€000)	Details
Offices	Office property in France	432,000	This comprises an office under construction in Paris with a total lettable area of X, valued using a DCF method. The property is x% complete and y% pre-let.
	Office property in Netherlands	272,000	This comprises an office tower in Amsterdam leased, on completion, for 20 years to a semi-governmental organisation. The property is x% complete and delivery is expected in yy months. The valuation uses a DCF method.
Retail	Retail property in Spain	780,000	This comprises a large scale shopping mall under development in Madrid with total lettable area of X. The development is valued using the residual method. The property is x% complete and y% pre-let.
Mixed	Mixed-use in Egypt	100,000	Comprises retail and residential under development in Cairo. This development is carried at cost as fair value cannot yet be reliably determined (see note D). Construction has just started and the pre-let percentage is below 10%. It is highly likely that fair value of this development lies within plus or minus 50% of the carrying amount.
Total		**1,584,000**	

25 *Except for the information on IP carried at cost (IAS 40 paragraph 78), additional information as disclosed here is optional and not prescribed by IAS 40. Comparative fair value information has not been disclosed as IPUC were carried at cost less impairment and presented as property under construction as at 31 December 2008.*

5 Conclusion

The changes proposed by the IASB have generally been welcomed because:

- They overcome an existing inconsistency within IAS 40 whereby properties under redevelopment are measured under that standard, whilst properties under construction are not.
- Most properties under construction will now be either carried at fair value or have the fair value disclosed, thereby providing investors with additional information on the profit potential of IPUC.

There is some concern that, as the valuation of IPUC involves more uncertainty than completed property, the income statement will become increasingly volatile. However, this view does not take into account existing accounting under the cost model where there is also volatility caused by recognising the entirety of development profits in the year of completion.

Needless to say, the results of investors/developers will depend more than ever on the valuations made by real estate appraisers. Accordingly, the inherent valuation uncertainty in balance sheets will increase. The assumptions made by appraisers can have a decisive impact and so, for the investor, disclosure of such assumptions is critical.

Appendix — methods used for valuing investment properties under construction

Discounted cash flow analysis

The discounted cash flow analysis, as an accepted methodology within the income approach to valuation, involves the projection of a series of periodic cash flows either to an operating property or a development property. To this projected cash flow series, an appropriate, market-derived discount rate is applied to establish an indication of the present value of the income stream associated with the property. For development properties the calculated periodic cash flow is typically estimated as gross income less vacancy and collection losses and less operating expenses/outgoings. The series of periodic net operating incomes, along with an estimate of the reversion/terminal value, anticipated at the end of the projection period, is then discounted. The aggregation of the net present values leads to the market value of the property.

Residual approach

This is a combination of the income and cost approaches. The residual method is defined according to the "Approved European Property Valuation Standards" of the The European Group of Valuers' Associations (TEGoVA), as:

"... a method of determining the value of a property which has potential for development, redevelopment or refurbishment. The estimated total cost of the work, including fees and other associated expenditures, plus allowance for interest, developer's risk and profit, is deducted from the gross value of the completed project. The resultant figure is then adjusted back to the date of valuation to give the residual value. Elements of the cost approach (as completed) are used in order to estimate the construction costs of the Subject Property."

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