Common Errors - Investment Property
19/10/2023

CCH Learning:

Hi, everyone. Welcome to today's webinar regarding Common Errors - Investment Property. I'm Alison Wood from CCH Learning, Wolters Kluwer, and I'll be your moderator for today. Just a few quick pointers before we get started. If you're looking for your PowerPoint, it's just saved in the handout section of the go-to webinar panel. And shortly after the session today, you will receive an email letting you know when the recording is ready to be viewed. In terms of questions, you can pop those into the questions box at any stage during the session, and I will collate those and ask them at the Q&A at the end of today's presentation.

CCH Learning also offers a subscription service, which many people have termed Netflix for professionals. It provides members with access to an entire library of recordings as well as live webinars for a very competitive flat fee, that's for over 400 hours of content. And for CPD purposes, your viewing is recorded automatically.

Your presenter today is Dean Ardern, director of BDO Australia. Dean has been advising on IFRS and other financial reporting matters for over 15 years. Having worked with a range of clients in both the profit and not-for-profit sectors, Dean understands the challenges preparers face. Dean's primary role is to identify practical and compliant reporting solutions for clients and assurance staff. To achieve this, Dean works at building constructive relationships with clients with the view to providing responsive, accurate and outcome-focused technical advice and guidance. So without any further ado, I will pass you over to Dean to commence today's presentation.

Dean Ardern:

Thanks, Alison. Can you see my screen? All good?

CCH Learning:

Yes.

Dean Ardern:

Excellent. Excellent.

CCH Learning:

Maybe just drop it back. Sorry, Dean. Just don't choose the clean screen option, if that makes sense, just because it chops off the bottom.

Dean Ardern:

Yeah. How's that?

CCH Learning:

Beautiful. Thank you.

Dean Ardern:

Excellent. Thank you, Alison.

Talking today about common errors in investment property. Now in the past couple of presentations, what we've done is I've structured the presentation in such a way as looking at scope, definitions, initial measurement, initial recognition, subsequent measurement in the same way that the accounting standards are structured. And the reason for that is to perhaps break it down and make it a little bit more digestible around what are the actual key areas that we find, where the errors arise.

Obviously in the last couple of presentations, what I've really done is focused on those particular areas to make sure that everyone... It's obviously a bit of a refresher, but also to absolutely be able to identify, okay, at what stage am I at with regards to dealing with an asset and therefore, what should I be concerned about at that particular stage and how I should ensure that what I'm doing is compliant with the accounting standards, but also I'm giving myself confidence that I'm actually applying the standard as it's actually required?

I've got there on that slide today, the various areas we're going to cover. I'm going to bundle up into introduction, scope and definitions together. I'm going to look at property with a dual purpose. This is probably one area that investment property differs from other assets. Typically, when we talked about, say, property plant equipment and intangible assets, they typically have one use. But when you're dealing with investment property, sometimes the property itself could have multiple uses, and then what are the implications of that for actually classification? Because probably, as I've probably mentioned a million times before in previous presentations, different accounting standards have different requirements.

Typically, the reason we have different accounting standards is because ultimately the requirements are very different. And so, as a consequence of incorrect classification upfront, you can get the incorrect accounting. So once you're on that conveyor belt of choosing a particular accounting standard, the chances are that the outcomes are not going to be the same as what they had been if you've chosen another accounting standard. So to make sure that you're in the right accounting standard for the first instance, we will help to facilitate the right accounting. But if you're in the wrong accounting standard from the first instance, there is every chance that the accounting won't be right. So, it's important to understand that.

We're going to look at initial recognition and measurement. After initial recognition, we're going to look at reclassifications because sometimes you see that investment property changes from investment property to PP&E and backwards or even to inventory, and what we do in those circumstances. Looking at disposals, and also looking at both subject to a lease because you can have investment property as a lease, as well as having physical property as an investment property. To save the bandwidth, I might turn off my camera at this stage and you can just focus on the actual slides.

As we do always, just like to begin by acknowledging the traditional owners of the land on which we meet today and pay our respects to elders past, present and emerging. And obviously, we extend that respect to Aboriginal and Torres Strait Islander people here today on the webinar.

As an introduction, as I mentioned, I just want to give you a quick overview. I think I've done it with previous presentations, just to give you a sense of the standard. The standard looks very similar in its... I suppose, the nuts and bolts of it look very similar to other standards like PP&E and intangible assets. So you start out thinking about, does the item qualify for recognition? Actually, does it meet the definition of an investment property? Alternatively, does actually meet the definition, and then is it outside the scope of the standard? If it meets the definition, it's still within the scope of the standard, then you're actually into the standard and you're saying, "Okay, I've got to initially measure it."

Like PP&E, it's at cost, but unlike PP&E, you have two models in the investment property standard. One's the cost model, which looks like the PP&E cost model, the other one's the fair value model, which doesn't look the same necessarily as the PP&E model. The critical difference is, is that fair value movements on investment property go through profit and loss in the year in which they occur. In respect to derecognition, very similar expectations around and very similar requirements as PP&E, but that's probably that critical thing.

As I mentioned before, so just reiterating that fact that if you get into the wrong accounting standard, if you apply the wrong accounting standard, the chances are that your accounting's not going to be right. In this case, you can see that the cost model is similar to PP&E, but the fair value model is not. And so as a consequence in this case you could probably say, "Look, there's a 50/50 chance I'm going to get it right." Not really what you probably want to be at. You really want to be in the situation where you've got the right accounting standard and therefore your implications is you've got the right choices around different measurement models.

Now we look at scope and definitions, and this is where obviously often we find that the errors are made. Really important to make sure that when you're dealing with an item of an asset and thinking it's an investment property, making sure that it actually meets all of the definitional criteria of an investment property. IAS 40 basically gives us a definition of an investment property, it's a property. Now, it's important just to note this: land or a building or a part of a building or both. Now, it's interesting, what the definition is actually straight up saying to us is that the unit of account for an investment property could be smaller than maybe the legal or the physical aspect of the asset. We're on notice. We have to think about, okay, investment property can be both a whole piece of land and building or it could be part of a land and building.

Held by the owner or by the lessee as a right-of-use asset. So again, beyond notice, we've now been told the definition is saying to us, okay, it could be owned or it could actually be a leased asset 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 for the sale in the ordinary course of business. Now when we think about that, those last two dot points, I mean if you just project your mind a bit and you think to yourself, well, what is that excluding? I mean obviously the first dot point is probably excluding property, plant and equipment and the second dot point is excluding inventory. So it's making it clear, yeah, there might be property, plant and equipment that would otherwise meet that definition of investment property, but because it's been used for production of supply of goods or services or administrative purposes, it's actually outside of the definition and therefore it doesn't fall within the standard. And similarly with inventory, but I'll come back to that later.

The owner-occupied definition, I'll put it in there, it'll come back later, but it's relevant to note, it's clarifying that it's property held by the owner or by the lessee as a right-of-use asset for use in the production of supply of goods or services or for administrative purposes. You probably already guessed that that definition is being introduced to make it clear that if you've got owner-occupied property, if it meets that definition, then it won't be investment property, it's going to have to go to another accounting standard.

Now if we look at IAS 40 in terms of the scope, it applies to all accounting for all items of investment property except when another standard requires or permits a different accounting treatment such as leases. We'll come back to this, but part of the standard, IAS 40 effectively covers leases that are meeting the definition of an investment property, but it doesn't cover all aspects of leases that are investment property. For example, IAS 40, as you imagine, doesn't cover the accounting for the lease liability, and so as a consequence, it's only the right-of-use asset that could potentially fall within the scope of IAS 40, but it does anticipate it's possible. If there's no requirements in IAS 40 around a particular item, then you'd expect that it's actually within another accounting standard and you'd need to find that applicable standard and work out how to account for that part that's not within the scope of IAS 40.

So it makes it really clear. IAS 40 says the standard doesn't apply to things like biological assets related to agricultural activity and it doesn't apply to mineral rights and mineral reserves such as oil, natural gas, similar non-regenerative resources. Now, the reason they often would explicitly state that these assets don't apply is because either there's another accounting standard that applies. So with regards to biological assets, you have to go to IAS 41 and IAS 16, but when it comes to mineral rights and mineral reserves such as oil and natural gas, there isn't actually a specific accounting standard. We've got an exploration evaluation standard that deals with extractive industries, but not necessarily with things like mineral rights and mineral reserves. So the standard is actually making it absolutely clear you're going to have to go somewhere else for these particular items if you have them.

Probably at the very top, I think the important thing is to understand that there's usually a little bit of professional judgement required. So property interest, it could be classified as investment property, property, plant and equipment, or inventory. Now I've seen investment property that is in part property, plant and equipment and in part investment property. I have seen assets which, depending on what your unit of account is, you might say, look, I've got a whole group of properties, one of which is an investment, and they might all be physically near each other or even linked, but one of them I can identify as an investment property and others I can identify as inventory for various reasons. So sometimes there's a little bit of professional judgement .

When we use the term professional judgement , we're not saying, you've got a choice. What we're saying is that sometimes you have to make judgements around what you think are the most important features and how that particular item, its characteristics meet the definition that you're dealing with. So thinking back to the definition as saying, well, in this case I might find, for example, and we'll come to it in a minute, but we might find that an investment property comprises in some ways some things which have features of property, plant and equipment and then you have to make a judgement about whether or not they're significant or not. So it's not an accounting choice, it's more about saying what do I think is more insignificant or what do I think is more important here? Which parts of the definition am I relying on? And applying that judgement to determine whether something is or is outside of the scope of the standard.

I mentioned there, classification of a property interest. It really depends on its use and then it comes down to, well, okay, when I'm thinking about use, is the use in my ordinary activities or in my course of business? What am I actually using it for? The specific facts and circumstances and the business model that actually the property interest is sort of subjected to, so including the entity's intention. For example, you can get scenarios where property is investment property and you are intending to develop it for sale, but for example, your normal ordinary activities is not the development of property for sale. And so as a consequence it wouldn't meet the definition of an inventory. So that's what I mean about the professional judgement . It's important to understand the asset, the features of it, what its intentions are, what's going on to really be able to ensure that that classification is correct.

As examples of what's an investment property, provided there. Look, basically a summary in that slide. So it includes land held for long-term capital appreciation rather than short-term sale. Land held for currently undetermined future use, and that's something that people often don't realise is that there might be a case where you've acquired land and you might be banking it. Now you haven't actually decided what you're going to do with it and you might in the future develop a business that is subdivision and sale or you might simply just resell it again and then you have to think about what the use or what the classification of that asset is at that time. However, at the point in time where you haven't determined what the future use of the land is, it actually falls within the scope of investment property because the implication is, well, if we can't identify it, you're probably using it for capital gain.

Also, building owned by the entity or a right-of-use asset hold on a lease, but it's leased under one or more operating leases. So you're actually in turn you are a lessee, but in turn you are a lessor as well. Includes vacant buildings that's held to be leased out under one or more operating leases. So it's not actually subject to a lease, but the intention is. And lastly, they're a property under construction or development for future uses and investment property that wouldn't otherwise meet the definition of an inventory. So it might be property that you've held in the past maybe for operating purposes, but at this point in time you've decided to develop it for sale.

We are seeing a bit of that kind of activity going on actually right around Australia at the moment where entities are realising they've got excess land and looking at ways of actually utilising that land, but often it's not their primary objective so they're not actually in the business of developing land. They'll actually engage with a developer to actually do the work and actually work through the whole process of getting it rezoned, getting designs put in place, planning permits and so on. And so someone else is doing it for them. They're providing the land and so there actually, in that situation, the land wouldn't necessarily change classification of inventory because it's not in their ordinary course of business to be developing land.

So examples of what is, now let's see some examples of what isn't. So property intended for sale in the ordinary course of business, generally that'll be inventory. A property in the process of construction and the property is intended for sale in the ordinary courses, again, inventory. Owner-occupied property typically will be property, plant and equipment. And property leased to another entity under a finance lease, effectively that is from your perspective as a lessor, you've actually sold the right-of-use asset. The asset you've got at that point in time is actually receivable like a financial asset as opposed to a physical asset.

I think I mentioned this in the last presentation on property, plant and equipment. I'll mention it again. There is an interaction particularly for Australian entities under AASB 140 in respect to properties held by not-for-profit entities. So I think I've mentioned in the past AASB standards are a little bit distinct from IFRS standards in the sense that they're applicable to both for-profit and not-for-profit entities. And what the AASB have done in the past is put in place some guidance and sometimes some additional requirements in those standards, not-for-profit specific requirements that then help not-for-profit entities interpret and apply that standard.

In respect to not-for-profit entities, a property might be held to meet service delivery objectives rather than earn rental or for capital appreciation. In such situations the property will not meet the definition of investment property and be accounted for under AASB 116. For example, property held for strategic purposes, which, if you were a for-profit entity, you might otherwise classify that as investment property, but for not-for-profit entities, they actually have to treat it as something else. And property held to provide a social service including those which generate cash inflows where rental revenue is incidental to the purpose of holding the property.

Now, I've dealt with and have clients who often will be involved in rental arrangements, so they will rent property and then they will in turn rent that property to clients. And one of the key reasons they might do that is because they are in turn then helping the client with some social services that they're also providing. So the property is actually sort of ancillary to what they do. Often the reason why they're involved in that property rental arrangement is to really facilitate the provision of the service, not necessarily to give them accommodation. The facilitation of the service is really improved by virtue of the fact that the person has a roof over their head if they're finding that they're having difficulties with permanent accommodation. And so as a consequence, the fundamental reason that they get involved in the rental arrangement is really to facilitate that service.

Now in that situation, AASB 140 basically says, look, in that situation, the real objective as a not-for-profit entity is not necessarily to provide rental or to get capital gain. What they're doing is providing services and if they're providing services, then it really doesn't matter why they're holding the assets otherwise. It's important then to classify it effectively as something like PP&E, it's not going to be able to meet the criteria for investment property recognition.

What could possibly go wrong? Okay, so there's a few things that can go wrong. Now, investment property standard is relatively simple. It's relatively straightforward in the sense that once you get beyond the scope and the definitions, generally the requirements are pretty straightforward and that's often where we find sometimes the mistakes go wrong. So distinguishing between arrangements where an entity has a legal title investment property and where it has a right to use. Now sometimes we do find that it's not quite clear, particularly when you're dealing in the not-for-profit space, sometimes the legal title and the right of use might be difficult to distinguish in the sense that the lease might be forever or for a very, very long time.

Another scenario, how do I account for land that might be used in the future for production or supply of goods or services, but management hasn't yet determined? Now I mentioned before that would typically be treated as investment property, but we still do see entities sometimes making that error because it's not entirely clear to them. Often when they think of investment property, they think, "Well, I haven't got into the investment property world yet. I just haven't decided what I'm going to do with it." But it's a default classification, it's not a choice or it's not one driven by necessarily an action.

Not-for-profit entities accounting for property held to meet service delivery objectives as investment property. We sometimes see that because sometimes there will be beneficial arrangements around those rentals and they see those rentals as giving rise to assets. And how do I account for property held for capital gains and leased to another group entity for operational purposes? Sometimes you do see that within groups, corporate entity groups. How do I do it? Well, from the owner maybe's perspective and the lessor's perspective, it might be regarded as an investment property. But when you're doing the group accounts, then typically it's not because from the group's perspective, if the property is being used for administrative or operational purposes, then it's actually going to be PP&E. So it's important to think about where we're within the group. If the property is being used within the group, what's its classification at the various levels within that group?

Property with a dual purpose. I mentioned, I alluded to this before, but the idea that you can get scenarios where, for example, an owner might in turn rent a part of a property. A couple of examples there, extra marks for anyone who can identify the building on the left. It's quite a famous building in New York. But you do find scenarios where entities will have maybe owning parts of buildings and maybe using one part of that building for administrative purposes, it might be a property manager or something like that, and using the additional areas that they hold actually for the rent. You can have those and, as I alluded to in the definition of an investment property, there is the prospect that you can actually classify those parts of the property that you own. So you ignore the legal ownership aspect and you say, well, what's the unit of account? If part of it's being held for investment property purposes, it is feasible that I can actually classify it as investment property, not withstanding it's linked to another part of the property that I maybe use for administrative purposes. How do I do that?

We have to think about those portions and you need to be able to separately identify them. So if we account for portions separately, if those separable portions can be sold or leased out separately under a finance lease. So the standard is saying, yep, not a problem. You can have a physical property and you can divide it between PP&E and investment property, but you need to be able to separately account for those portions. We need to be able to separate those portions either by being able to be sold or leased separately under a finance lease.

So the important part there is to identify that you don't necessarily have to have sold it, but you must be able to sell it or lease it separately and then you can identify the investment property portion. It's the portion that's held for the rentals and then the rest of it is classified as PP&E. Now if the portions can't be sold or finance leased separately, you've got to account for the investment property only if an insignificant portion is used in production or supply of goods or services or for administrative purposes. And this is where that professional judgement also comes into play. So the idea of what's insignificant.

Now, I'm not asking you to answer this question, I've just posed it as an issue to talk about, but what do we do with property that serves dual purposes and we're dealing with a scenario where there's an insignificant amount? How do we define insignificant? Well, how do we determine insignificant? It's not actually defined in the accounting standards. Floor space might be one basis on it. So where do you think that you draw the line about significant, what is insignificant? Is it 5%, is it 7%, is it 10%, is it 15%? I'm talking about the PP&E component, the administrative or services-based component of the office.

And you do see this a lot where entities will often rent a larger portion of a building, but in the expectation that at the time that they're renting it, at the time they enter the rental agreement, they don't necessarily require all of it, but they might require some of it in the future. So they might enter that and enter a separate agreement, a subdivide, provide the sub-lessee separate access to their part, but with the expectation at some point in the time they might use it as office space. I would imagine that it's somewhere in that 5 to 7% is where you're probably thinking it's insignificant. I think, if you're getting towards maybe even 7%, you might say it's starting to get a little bit high, but again, professional judgement apply. If we're talking about 1%, probably pretty comfortable. I'm not going to give you a black line to draw under this, but just to keep in mind that obviously once you start to head the tour, something that's insignificant is probably something possibly less than material. So it's important to consider how those terms relate to each other.

Now ancillary services is another one. I think I mentioned it before, the idea that certainly when it comes to not-for-profits, they generally provide ancillary services, but these ancillary services often in those service-based industries are often more significant. You still see some ancillary services in investment property and in conjunction usually they're being provided by third party sometimes or facilitated by the lessor with third parties. Now these ancillary services are actually key to determining, again, a difference between investment property and PP&E. So are you using the property for purely for rental and capital gain or are you using it for some service-based aspect?

Examples of arrangements that involve provision of ancillary service include hotels, service departments, aged care facilities, holiday lets, short-term storage facilities, and maybe shopping malls and markets. If you think about all of those differences, there'll be an element of it's not just that you walk in. So with a hotel you don't just simply have a room, there'll be other services provided as part of that. There's room keeping, there's going to be property restaurants, there's going to be bars, there's going to be concierge, there's going to be other assistance that you can provide. So when you pay your nightly or weekly hotel bill, as a part of that bill, you're actually buying services, whether you use them or not is another thing.

And the same with a lot of those other ones. Particularly, age care is the same, is that usually the accommodation in some ways is actually not a significant sort of role. Again, depending on the level of care involved in the aged care facilities. But all of those scenarios have services relate to them. So if you own them and you're providing those types of services, you have to think to yourself, actually, is this an investment property or is it PP&E?

I think this is pretty much summarising what I've said before, so I might just skip through that one. And I suppose that then we say, well, look what could possibly go wrong? So when we're thinking about ancillary and we're thinking about significant, we have to ask ourselves, well, what would we normally expect to see in other type of maybe things that are otherwise classified as investment property? It's not uncommon to see security services and they're often not considered significant because they're a small part of it and particularly it might be simply that they've arranged for a third party to be involved in providing security. Cleaning and maintenance is another one. If we're starting to move into front desk and concierge services, then that's a slightly different scenario. Waste and recycling's not an uncommon thing that you see through investment property and provision of electricity, gas and telephone. Internet's another one.

The kind of thing I'm trying to highlight here is that you can get a spectrum of potential ways in which entities use assets. The same entity could own an asset, like a hotel and actually operate the hotel, or an entity could actually own a hotel and then in turn just simply rent that hotel to a third party who operates the property as a hotel. Now in the first instance you would probably argue, yeah, it's PP&E, whereas in the second instance where it rents to a third party, then you probably conclude, yeah, look, that looks like an investment property. The trouble is you can get scenarios in between. For example, I might not operate all aspects of the property of the hotel. I might only provide some of those services. Does that in turn mean that the property is or isn't an investment property? And again, this is where judgement comes involved.

So initial recognition and measurement. I'll premise this straight up, it looks very much like the criteria around initial recognition and measurement of PP&E, so property, plant and equipment. And that's not by sheer chance. The standard setters thought that these things look similar. It's really ultimately what they're used for is the difference and therefore perhaps the performance of the asset is more important than necessarily the initial recognition and measurement. And therefore those criteria around initial recognition and measurement couldn't be aligned with PP&E because really at that level and at that stage, the assets don't differ that much between PP&E and investment property.

So you go through the typical evaluation criteria for property costs, is it probable that future economic benefits associated with expenditure will flow to the entity? So if you bought the property or if you're building it, yes. Can the expenditure be reliably measured if you're building it? Typically, yes. If you bought it? Typically, yes. And what do I do then? Well, capitalise. So it's not a unique and it's not a... I suppose it poses no more challenges than what you would find in property, plant and equipment, but probably, again, that helps to sort of direct us where to think about where the problems might arise.

So costs that we typically see associated with investment property, you see feasibility studies, market research, purchase prices, lease costs. I'm not saying that these costs are capitalizable, I'm just saying these are the types of costs that you see. In terms of subsequent costs, you've got redevelopment and replacements and refurbishments. And servicing costs. You've always got cleaning, utilities, repairs and maintenance and so on. So there's a broad range of costs, similar property costs that you get with PP&E.

Then the question is, exactly what can be capitalised and what's to be expensed? So cost incurred after initial recognition includes subsequent expenditure and servicing cost. Again, that can be challenging. I'll come back to those. And an entity evaluates all subsequent expenditure associated with investment property to determine whether it meets the general recognition criteria. So the general recognition criteria look very similar to PP&E. So it's, again, can you measure it? Is it going to give you future economic benefit? And where they don't meet those criteria, then you obviously expense those costs. Like PP&E, investment property measures at its initial cost, transaction costs included in initial measurement amount.

Now this is probably where the rubber hits the road. So when it comes to the costs, what's included and excluded, so in the same sense as we do with PP&E, we include purchase price, directly attributable expenditure like professional fees, transfer taxes, transaction costs. The cash price equivalent for deferred payment terms. So, for example, if there's an issue around if the consideration is being deferred and paid over a period of time, if there's a financing aspect to it, then the cash price, you need to be able to identify that. And then costs are necessary to bring the property in the condition necessary for it to be capable of operating in the manner intended by management. Again, similar criteria as PP&E, not surprising. It's really principle based and it's simply saying, well, would you have had to otherwise incurred this cost to get this asset to a stage where you could use it as you wanted it to? And if the answer is yes, typically we capitalise. If it's not necessary, then typically we expense it.

Now things that are explicitly excluded under the standard in terms of costs, so operating losses incurred before planned level of occupancy reached. Again, these are costs that are not necessarily going to contribute to the benefits of the asset, it's just simply those costs are effectively wastage costs. Again, wastage, you have normal amounts of waste of material, labour, other resources incurred in constructing. The cost of the property interest held under lease or by way an exchange of assets. Again, we don't impute necessarily interest on those things. And costs that are not necessary in bringing the property into the condition necessary capable of operating in the manner intended by management. The kinds of ones that probably fit into that last category are things like maybe KMP time around deciding what to do with the asset. If you think about that, that decision itself doesn't necessarily add to the value of the property. If the KMP were negotiating with a construction company about how to develop an investment property, then arguably that might be something that you consider for capitalization because obviously those efforts would in turn ultimately I imagine contribute to the benefits of the asset.

I'm not going to dwell on this much, because I don't see it very often, but I know the standard sort of makes it, and I'll come back to this, the IAS 40 and AASB 140 are an interesting standard because they do seem to contain some requirements that seem to be a bit dated and one of them is non-cash exchanges. So there is some discussion around non-cash exchanges. I might just skip through it because I don't see it very often and I don't see it necessarily as something that often entities get involved in, but it's there.

So you should keep in mind that really what you're trying to do is, if you're having a situation where assets are exchanged rather than necessarily cash and trying to work out what the cost is, and it's there on the slide, the entity measures the cost of an exchanged investment property in this way, even if it cannot immediately derecognize the asset given up. So you're looking at basically what are you exchanging at fair value to basically recognise it and that's the key part of it. Again, we don't see a lot of that going on, so I might just push past it.

Borrowing costs, we do see that a lot and so it's important to understand exactly what the criteria in the IAS 23 are around borrowing costs. I mean effectively borrowing costs are a costs of doing it, but it's important to understand that there is a start and an end date with borrowing costs. Now, you might borrow money specifically for a particular construction or there might be a general pool of borrowings within the entity that's drawn upon to perform the work. In either case, there is the capacity to take some of that interest and capitalise it, but it's important to understand that you need to know when the start and the end date is for. So once the asset is in a condition that's ready for use, notwithstanding it might not be used for that use, once it's ready for use, that's when the capitalization must stop in respect to all costs, but also including interest costs if you're applying that, if you're actually capitalising borrowing costs for it.

What could possibly go wrong? The first one, same with PP&E, overcapitalizing. So you might get scenarios where entities capitalise too much and they overcapitalize or they don't qualify for capitalization. So, for example, I mentioned before operating losses incurred before planned level of occupancy reached. Continuing to capitalise costs after the item of property is in the location and condition necessary to be capable to be used. A good one for that is borrowing costs. Often entities don't catch that point in time because there's sort of a disconnect between their finance function and maybe their construction function that the construction function doesn't know that they have to let the finance function know, "Hey, the work's finished. Stop capitalising costs." Because they don't know what's going on. And to the same extent the finance function might not actually know to actually ask the construction part to say, "Actually, have you finished yet, or not?" Sometimes there's an element a bit between the operations and the finance that have to be communicating around this.

Where it does finance the construction using borrowings, the requirements need to be considered as borrowing costs capitalised as part of the cost where recognition criteria is met. So again, it has to be a qualifying asset, has to make sure that you actually, if, for example, you're using the general approach, you're proportioning the interest appropriately across the construction. You'd expect to see the same principles applicable where the entity contracts someone else to actually construct an asset. But again, it's important to understand, I think I mentioned in past things, when you're looking at those sort of contracts, be aware there might be some embedded things in there that you're paying for that are not related to the construction of the building. And so, for example, there might be some training, there might be some other aspects that you're paying for which are not related to, it's not money that's going to go directly into construction of the building, it might be related to some sort of services you're getting. So you need to be conscious of those.

Componentization, I mean, again, with investment property it's quite common to find componentization around particularly investment property that's leased out. Often the lessor is responsible for things like air conditioning and those sort of things, escalators, other parts of the building that might not have the same lifespan as perhaps the building as a whole. And so componentization is really important to make sure that you're actually, you are dealing with those parts of the building that can be separately identified and measured and accounted for and appreciated appropriately over their different use for life. And that's an important part about it, the componentization style.

Measurement after initial recognition, like I mentioned before, this is the part of the standard that differs. And so, we sort of track along through the standard and it mainly predominantly looks like PP&E standard, it has similar sort of principles and all that. But also when you get to subsequent measurement, this is where things diverge. So you still have the cost model which is the same as the PP&E model, but you've now got the fair value model, which is effectively like a fair value model for financial instruments. It's just fair value through P&L. It's very, very straightforward. So there is an accounting policy choice, but you've got to do it for class of investment property. And so if you choose it for one item of investment property, if you choose, for example, fair value for one item of investment property, then it has to be applied to all of them.

And you can understand the standard setters' perspective here is they're simply saying, "Look, you can't cherry-pick what you think is the best way." You might think, "Oh, this property over here is going to go up in value but my other ones are going to go down. Hey, let's just apply fair value to that one to cherry-pick that and I'll treat the other ones at cost." You can't do that. And so it's a way of avoiding, and I can see the standard setters' arguments is that if you think that this information about that particular property is relevant to users, why wouldn't that information be equally relevant in respect to your other properties for users? And so you can't make that choice on an individual asset basis. You have to make it on a asset class basis.

Now the interesting thing about the standard is you can't sort of get away from fair value irrespective if you choose cost model. There is an expectation under the cost model that you've also disclosed the fair value of the assets of the investment property. Notwithstanding you might not apply the model and therefore what happens with that is, is that when you disclose value information, it's going to be subject the disclosure requirements in IFRS 13 or AASB 13. So you should be aware of that as well. Notwithstanding you're not measuring the asset at fair value, if you disclose fair value information, that fair value information is also subject to the requirements under IFRS 13.

There's a couple of exceptions and, again, it's an interesting accounting standard. I'll come to the exceptional one, I think it's the third dot point, but I'll come to it in a minute. There's a couple of exceptions to these accounting policy rules. One is that you can choose either fair value or cost model for all investment property backing liabilities that pay a return linked directly to the fair value of or returns from specified assets including the investment property regardless of the accounting policy choice for all other investment properties. Now you might ask yourself, well, how does that apply? That typically applies in respect to insurers and other similar entities who have investment property backing liabilities to pay a return linked directly to the fair value of those assets. What you sometimes see is groups of insurance policies links to assets and then you find that there's a relationship between the value of the asset and obviously the value of the liability. You wouldn't typically see this type of arrangement outside of things like insurance companies or maybe superannuation plans. It's rarely relevant to them, not particularly relevant to others.

The second dot point there, so accounting policy available for investment property held directly is also available for investment property held by a lessee as a right-of-use asset. Now, I think I've sort of alluded to that before and I suppose the important thing to remember there too is if you do that for a right-of-use asset, you'd have to do it for the equivalent investment property held directly. But it says however, when lease payments are at market rates, fair value of the investment property net of all expected lease payments should be zero.

So it's important to keep in mind when you fair value a right-of-use asset, you would typically only get a number that differs materially from the liability amount if it's a really, really good lease in the sense it's either below market conditions or it's really valuable, it's on a great spot and you haven't paid less for it than perhaps what the market would otherwise rate. So it's important to remember that notwithstanding that option is available, you don't necessarily always get a fair value number for right-of-use assets that looks like an investment property because of the nature of the asset, it's really limited by what you're paying and what the market is for.

Now, I mentioned there the third one. In exceptional cases, where there's clear evidence on initial recognition that the fair value of the investment property is not reliably measurable on a continuing basis, such as when the market for comparable properties is inactive and alternative reliable measurements of fair value not available, in which case the specific property is measured at cost. Now, this requirement was put in the standard when it was initially, in fact it might might've predated the standard being translated into IFRS. We don't see this very often. It's not common, in fact, I can't say I've ever seen a circumstance where a fair value for investment property can't be determined. There might be cases where property is in very, very remote locations, but I'd question the situation there and say, "Well, why are you holding an asset in such a remote location? Is it being held for some other reason other than..." And it might be a case that it gets into the investment property classification because there isn't an unspecified use issue.

But I can't say that I've ever seen a situation where at least in semi-rural, semi-developed areas where a property can't be measured at fair value. So I think these requirements were put in place years ago and they were really to help some jurisdictions, probably not Australia, not the UK, not the US. There are some other jurisdictions where the standard setters in those jurisdictions said, "Look, we're finding it difficult to get people to value properties or we're finding that some of the fair values are not particularly reliable." I don't see that that's necessarily an issue here. So I don't often see that last dot point of exceptional cases coming up very often at all.

The cost model looks very much like the cost model in AASB 116. After initial recognition, you apply costs, you basically depreciate and apply impairment losses if it's applicable. Repairs, maintenance, enhancements. Again, you capitalise them if they, again, meet that initial recognition criteria, are they going to add to the economic benefits of the asset and can they be reliably measured? If they don't meet those two criteria, if they're not going to add to the benefits of the item and they can't be reliably measured, then they should be expensed when incurred.

Subsequent costs. I mean, you really need to make that distinction between capitalization expense based on what you think it's actually going to do. This might be another area where some professional judgment's required, where perhaps you adopt an accounting policy and you make certain maybe bright line types of assessment but within the context of the principle. So you might say, "Look, only major inspections over and overalls over a certain dollar amount because of materiality." You might decide that that's the basis on which you capitalise and everything else below that's expense. So there's a materiality aspect to it. If you have assets that require regular replacements, what you might do is you might be able to say, well, all of these replacements will be treated as a capitalization because, for example, we know that they add to various things.

What could possibly go wrong? Well, lots of things, but all the same sort of things that go wrong with PP&E. So incorrectly capitalising costs that really should have been expensed. Your depreciation method maybe doesn't reflect the pattern of the asset's use. For example, if most of the economic benefits received during the early periods of the useful life, you wouldn't expect a straight line or alternatively the asset has an unlimited life if it's not used but its useful life reduces proportionately as usage increases. We don't typically see that in the context of PP&E or investment property, but there might be some aspects there. Maybe the depreciation applied is based on revenue. Now, standard explicitly says you can't do that because what you're trying to do is you're not reflecting the benefits provided. What you're doing is you're reflecting a smoothing of the cost approach. So, again, can't base depreciation on revenue. And making sure that your inputs on your depreciation are reviewed annually so you don't get in a situation where you become over or underestimated useful life or your residual value's incorrect. So all the same sort of things we see in PP&E.

The fair value model. Again, fair value, all prescribed under IFRS 13. So how do you do it? IAS 40 paragraph five and IFRS 13 define the fair value is what it is. So it's price that'd be received to sell an asset or transfer a liability. In this case it's going to sell the asset in an orderly transaction. That's what's important. I've often seen investment properties perhaps where situations have been that the entities had to sell not in an orderly transaction. And so you get these differences between what's booked in in the books and what actually it's going to be sold for. That does happen and so be aware of it. And it's got to reflect the calculation of the rental income from current leases and other assumptions that market participants would use. It's consistent with that IFRS 13 approach. And too, you need to remember that maybe some investment properties aren't their best and highest uses. They might be able to be used for other things, so the fair value might not reflect their current use. It might reflect some other use that maybe is not considered or not being currently used.

In terms of the actual, I suppose the mechanics of fair valuing under 13, really important, I suppose this is probably, I'll come to it in a minute, but it's really important to keep in mind that you are actually counting assets within assets. And so sometimes you get situations where you will have to be aware that there are some things that you might actually not be in the fair value measurement or you might have accounted for separately, but get drawn into the fair value measurement and making sure that you're not actually double counting those assets. And there's a list of them there. So you get equipment such as lifts or air conditioning, they might be integral to the building but not recorded as separate assets. Now, those ones you'd have to consider as part of the asset and part of the investment property, making sure that they're considered as a part of it.

Office leased furniture. So, for example, if the furniture is a part of the whole arrangement, making sure that you haven't got those separately as assets on your balance sheet, but part of the investment property balance. Prepaid and accrued operating lease income. Again, usually find that will be brought into the fair value valuation for the purpose of the property. And it reflects all fair value cash flows. I think I mentioned before the idea that it'd be unusual to see a right-of-use asset fair valued and that that fair value right-of-use asset would be greater than the lease liability. If you find that, then you need to sort of satisfy yourself, okay, there's a non-market feature here. So, for example, I'm getting this property really cheap or there's some other aspect to it that means it's a great value.

Also important to remember that, again, within some investment property you might find other assets. So, again, things like land that might be held with access to water. There might be irrigation licences attached to it or obviously casinos have gambling licence or other pubs have gaming licences attached to them and liquor licences as well. So these things might be separately recognised. You've got to think about are they part of the fair value or are they actually separate. Typically, those things are separate because they can be separately accounted for. They can typically be sold or they can be leased. So it's important to remember that double counting is probably one of the key areas.

And it's on a continuing basis. And this is probably something that people don't necessarily, and maybe this is not so much a mistake, but it's maybe a regret that they often have is that if you enter into the fair value model of IAS 40 that you actually have to continue valuing it at fair value. And you might have scenarios where from time to time prices might become more or less available, but typically they are available sufficiently enough to get valuations. What we do find clients is that there's an initial attraction to fair value things, but when they realise that they have to do it every year and they have to employ somebody to do it and often it'll cost them money, it's not always the most ideal outcome.

So it's always important that once you make that decision, you need to understand that you generally won't be going back to cost. The general principles in accounting are that if you move from cost of fair value as an accounting choice, you don't really get the choice to go back from fair value to cost because usually fair value is considered a more relevant reliable measure under AASB 108 and IAS 8. Again, I think I mentioned before that inability to measure fair value reliably, we don't often see that arising. So, I'm probably going to skip through this one on that basis.

What could possibly go wrong? Probably a few things. Using an income approach when comparable market sales is available. We often find some clients might emphasise one particular methodology for measuring fair value and it's not uncommon to see in valuation reports that there's a couple of ways will be looked at. And assuming that people will triangulate the valuations to get something that's close to a fair value. Because obviously income approach will get you close, comparable market sales will get you close, but often if you think of both of those are sort of proxy for the asset itself, not necessarily a direct valuation of the asset.

Assuming current use is the highest and best use. I mean that's really, particularly for lands and buildings. It's not uncommon to use land for something and always think it's going to be used for that, but in fact it might actually have some value. We also find that land over time can have different higher and best uses. For example, as other properties around it become developed, that property itself might then become more valuable as a development property. And I mentioned before those double counting lease incentives and additions to fittings and fixtures, et cetera. So making sure that when you think about the valuation, you're not double counting assets that are already on the balance sheet or that are not on the balance sheet.

Reclassifications. From time to time it occurs, but you might get scenarios where you've got to transfer to or from an investment property. In that case, transferring from those, there is an element of professional judgement required, but there are some very specific circumstances in which it will occur and those are there listed on the slide. For example, commencement of owner occupational development for owner occupation. Now you transfer it then from investment property owner occupied. Now it's really important that there may be some judgement involved there in the sense of day to day to day. You might say, "Well, is it yesterday, today, or tomorrow?"

But there isn't really a choice. I mean the idea is that you usually would say, "Look, for example, it might be a case we do this often, we use the date in which we actually sign on the developer to do the work and that's the date we transfer it." So it's not so much around the fact that you can choose when. It's more around about what's the trigger, what do you think is the actual significant event that occurs? Which then causes that reclassification. The standard's very clear on that and those amendments to the standard were made in the last couple of years to actually make it very clear because there was some uncertainty around when those events occur. Because if you think about subject to when they occur, you get different outcomes in your P&L, which is important to understand.

Now, as I mentioned there before, there's actually no guidance in the standard about when, so I'm talking about the actual date, but there is those requirements that you have to do it in principle at those particular times. And so as a consequence we find that if entities are involved in this regularly, we would say to them, it might be worthwhile to actually develop an accounting policy and think about how do you normally go about this. What's the timing of those things? And maybe aligning the timing in your accounting with timing some event that you can actually point to. So signing an agreement, physically moving, those sort of things. Things which can be sort of assessed and judged by the auditor.

Measurement implications. I mean obviously there are, and I won't go through them, but there's some very specific measurement requirements around when you're moving from one classification to another and because obviously once you... And it depends on which measurement methods you use too, in the sense of whether you go from cost to cost or cost of fair value. But if you're moving, for example, from owner-occupied investment at a property at fair value, you need to consider about how do I deal with that transition on day one because what's going to happen is I'm going to have a day one uplift or even an adjustment downwards depending on the nature of the property.

But it's important to remember, okay, there is some measurement implications here and so we have to go through it. Typically, what IAS 40 says is you're using basically a lot of the criteria in 15 around control and recognition of revenue, but using it in a way, applying it to assets. And there's also the requirements in 140 around actually what do we do with those uplifts? Typically, they are taken to a reserve on day one basically to avoid those day one uplifts. But also you need to be conscious of the fact it sort of works like IAS 16 too. So the idea is if you get a day one uplift and that reverses maybe a previous loss, how do you account for that? You do it in a similar way that IAS 16 does.

Again, measurement implications. You have those, you need to sort of be aware of them and make sure that you actually account for them in accordance with the standard. Lots of things can sort of go wrong, particularly around that reclassification. Adopting accounting policy for determining the timing is useful, but it's important that you actually align it with what the standard says. So the idea you might, and we do see sometimes where entities might say, "Oh, look, I'm just going to assume the transfer happens at the end in the reporting period." Now if you do that, you then are classifying all transfers during the whole year as at the end of the year and that can have significant measurement implications like a year of valuation of properties can be quite significantly different and also have material impacts on the financial statements of the investors.

So, thinking about aligning it with a standard but thinking about what is a good trigger point which is reflective of the fact of a change in use. I mean I think that critically the standard is trying to avoid situations where management have an opinion about when they think that they should, but their opinion may be influenced in part by what they think the valuations are doing. So it's important that to ensure that the audit can be properly undertaken, that those numbers are aligned with a certain event which reflects management's change in intention. It's not just simply management saying that they've changed intention but they've actually demonstrated they've changed intention. Other problems that might arise: adopting inconsistent accounting policies over time, so having a policy in one year and then changing it the next. Maybe recognising all remeasurements on transfer and P&L, which is not what the standard says, but then also maybe through OCI, again, not what the standard says.

Disposals, generally pretty straightforward. Typically, if you're in the fair value model, it's fair value right up to the date of disposal and effectively you don't really get any gain on disposal. Whereas for the cost model, you do have a gain on disposal. And I've just outlined those there in terms of how to deal with it.

Gains and losses. The critical part with gains and losses and recognising those is that they all go through P&L except for the fact that obviously with an investment property at fair value, then it's already going through a P&L. I suppose the key part is, again, the accounting standard with investment property, the same with PP&E, you're recognising the gain or loss on disposal. You're not recognising the gross proceeds and the gross cost. It's all about the gain or loss. The idea with that is, again, generally with PP&E is the same with investment property, with investment property you're going to have it going through a P&L anyway if it's fair value, but if it's a cost, the idea is maybe you're not assessing on that basis of a gross amount.

Compensation, don't see it very often, but be aware of it like there might be scenarios where an entity might be compensated like an insurance claim or something like that, but obviously those kinds of things where there's an insurance claim, there might be also associated impairments on the asset. So you need to be aware of those, ensuring that they're accounted for properly at the time that they occur.

Just last but not least, investment property subject to a lease. So I mentioned before the idea that you can have a lease property. It's held under lease may be counted for using cost or fair value model. Now the investment property under lease, when you apply the application of the fair value model to that, you need to be conscious of the fact that the asset being measured is the right-of-use asset, not the underlying property. So you're selling, you're talking about the right-of-use asset, my ability to rent that property and then I'll rent to someone else. So rental income will reflect the current leasing arrangements and other assumptions that market participants would use when they're pricing that asset.

And when lease payments are at market, the fair value of the right-of-use asset would generally be somewhere around the lease payments and therefore the difference between the asset and the liability should be somewhere around zero. So there shouldn't be any initial gain or loss on the leased investment property. And this is what this accounting standard sort of actually almost prescribed to be the case is that you wouldn't expect there to be this difference because, unless the thing's way below market, for some reason you've got this wonderful deal, unless you've got this wonderful deal, then you're basically going to have the net asset of the lease will be somewhere near zero.

Can property under lease be classified as investment? Well, we mentioned that before. Yeah, it can, but obviously it's got to be subject to meeting the definition of investment property. But again, the important thing people remember if they start to reclassify investment property under a lease as at fair value through P&L, then potentially any other investment property they have might also have to be measured subsequently at fair value through P&L. So you need to be very careful about whether or not you want to taint the entire investment property classification that you have if you want to go to fair value because, as I mentioned before, it's very hard to go backwards.

There is the prospect that you can get a day two gain. Now a day two gain is the fact that you have this issue about that from day one, particularly around the lease, if you're fair valuing a right-of-use asset, is that the accounting standard says, well, actually you can't. We expect that the asset and liabilities are equal, so we're not going to get a gain. But you might actually get a gain on day two because all of a sudden you've got a right-of-use asset that's a receivable and you might then in turn, it actually might be greater than the liability. It happens.

Many firms' position is that a gain can arise when you subsequently classify an investment property. So, for example, you might've held that right-of-use asset for a period of time and then when you actually reclassify subsequent to initial recognition the right-of-use asset, you'll get effectively a post gain. In that situation, we would expect that you would actually say, well, actually the standard is clear that those gains shouldn't arise. So that gain shouldn't be recognised. It's not something that actually would appear. So we'd expect that the asset would continue to be recognised at the amount that it was previously recognised at.

Alison, that brings me to the end.

CCH Learning:

Thank you very much, Dean. All right, conscious that we are just on two o'clock. We do have one question that has come through, so we will quickly fit that in and I'm sure Dean is a lovely man, so if anyone else wanted to quickly fit a question in, please do so. Pop it in the questions pane and then we can add it to the Q&A.

All right, quickly running through our upcoming webinars. 24 October, we're looking at NALI, updates from the ATO, also powers of attorney, then tax residency, also looking at insolvency, family law and property settlements, and then a session on accessing super benefits. So if you jump on the CCH Learning website, you can check out all those details.

Having a look at this question here, so Kevin's asked, "The standard requires an entity to measure investment property using the cost model if the fair value of the property can't be reliably measured on a continuing basis. Have you ever encountered circumstances where the fair value of investment property couldn't be reliably measured on a continuing basis?"

Dean Ardern:

Yeah, it's not a common thing we come across. I've seen a few scenarios where property is being held in quite remote areas. Because there's not many market transactions in that property, you might be struggling and it's not being used for anything in particular. It might be grazing land or something like that. There might not be any readily identifiable, comparable market sales and that might be one scenario where it might be difficult. But we generally find once you're in rural, semi-developed areas, investment properties, typically you can get a fair value for those things. So yeah, it's not a common thing we see. I think it's a bit of a hangover that part of the standard really to sort of past years. I always wondered whether or not the ISB was eventually going to actually remove that, but they haven't yet. So it's still sitting there. But the answer's no, I haven't seen anything significant in that front.

CCH Learning:

Perfect. Thank you, Dean. All right, that is all the questions that have come through for today. So we will just look at closing the session off here. So in terms of next steps, I'd just like to remind the audience that a feedback survey will pop up, so please take a moment to pop your opinions in there. Then in terms of the recording, you will receive an email this afternoon when that's ready. You can also access the PowerPoint transcript and ACPD certificate as well. So thank you very much to Dean for the session today, and thank you to everyone in the audience. We hope to see you back online for another CCH Learning webinar very soon.