

THE ISSUES OF RECOGNITION AND MEASUREMENT OF THE INVESTMENT PROPERTY ACCORDING TO IAS 40

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Abstract

Characteristics of the Investment Property differ critically from the characteristics of the property held by the owner. This is a complex economic object, where the owner of an enterprise earns the income from the property right on the immovable property, not from its physical use. This is the property held by the enterprises for earning the income from their lease or by their future sales by increase of their value, for the purposes of gaining a profit.

The information regarding the investment property is very actual for the users of the financial reporting. The issues of accounting of the investment property and the requirements of their reflection in the financial statements are determined in IAS 40 – “Investment Property”.

The present Article, on the grounds of generalization of theoretical and methodological provisions, considers the essence of the investment property as of the object of accounting, criteria of recognition, classification and measurement. Their formulation is based mainly on the international accounting standards and various scientific researches.

The Article provides discussions on the models of measurement of the investment property as an independent object of accounting after recognition thereof and, of reflection of the relevant changes in compliance with the international accounting standards. A special attention is paid to the fair value model of accounting and other conceptual issues related to the investment property.

Key words: investment property, cost model, fair value model, increase of capital

1. INTRODUCTION

The investment activity is one of the most important indicators of the economic development of any state and country. Besides, it determines a country's participation in the global economy.

For the purposes of gaining a profit, the companies often invest their free monetary resources in the immovable property. Classification as the investment property of a property held by its owner, is determined by a condition, of how and for which purpose this property will be used in future and, correspondingly, by which ways the money flows will be generated from such the property.

In general, the investment property is a long-term investment, which is related to the very low risks. Its value is increased continuously and deriving a benefit from it, is possible both by its sale in a short period and on the grounds of a long-term lease which is one of the attractive methods for diversification of an investor's portfolio and gaining a non-risk revenue. One more important factor that characterizes the investment property is that it compensates its value after a certain period and, remains under the ownership of its holder.

2. ECONOMIC ESSENCE OF THE INVESTMENT PROPERTY

Investment is a long-term investment of any monetary, property, intellectual values or rights in the industrial or other objects of own or foreign countries, which may be then used for gaining a possible profit or receiving the benefit of any other type.

The investment property as an object of the accounting, is defined by IAS 40 as follows: The Investment property is a property (land or a building or a part of a building or both) held (by the owner

or by a lessee under a finance lease) to earn rentals or for capital appreciation or both, except for the purposes, such as:

- a) Use in the production or supply of goods or services or for administrative purposes;
- b) Sale in the ordinary course of business.

As seen from this definition, a holder entity of the investment property receives the incomes by the ownership right on the immovable property, not by its physical use.

Generation of money flows through the investment property by a company, takes place independently from other assets. Just this factor makes a difference between the investment property and the property occupied by its owner, the application of which together with other assets, generates the money flow in the course of production and supply of the goods or rendering the services.

The investment property except for the property being let in the lease, includes also the objects, which are owned by a company for future sales in order to gain a profit from increase of their value. Such objects are not factually in use for a long time and, are in a higher extent related to accumulation of resources, rather than to spending.

For example, a company purchased the land plot for its future sale. This land plot may remain in the company's disposal without its use during decades, because the owner waits for increase of a value thereof.

The means of deriving the revenues are the essential factor in planning and controlling the investment property, because a time, a quantity, and the risks of receiving the expected money flows from these assets, depend thereon. In all these cases an entity is obliged to develop a relevant tactic and strategy and draft a preliminary report.

In practice, a situation may occur where a part of one and the same object is destined for making investments, while another part is used by the owner.

In this case, the Standard offers the following solution: If realization of let in a financial lease of the given object is possible to make independently, then they must be considered as separate units for the purpose of accounting, while if such a division is impossible, then the object may be classified as the investment property, if the owner thereof uses only an insignificant part thereof.

For example: A wood processing enterprise owns 3-storey building with a total area 550sq.m., of which 2 floors are let in lease, while 30sq.m. area on the third floor that forms 5.5% of the total building space, is used by the enterprise as its office.

Here it should be taken into consideration that the owner uses only an insignificant part of the whole building, therefore the whole building, must be classified as the investment property.

According to the Standard, identification of the immovable property as the investment property should be based upon a professional decision. For this, an entity must develop relevant criteria and use them consistently when identifying the investment property. Disclosure of the information regarding such criteria, is necessary in the financial reporting.

Definition of the investment property excludes:

- a) The property occupied by the owner, which is included in the IAS 16 "Property, Plant and Equipment". According to IAS 16, such the property is to be reflected with one of the following two: by the cost reduced as a result of depreciation, or by revaluated price, from which further depreciation is to be subtracted. Moreover, such the property must undergo the depreciation test.
- b) The property to be sold in conditions of ordinary activity of an entity is included in IAS 2 "Inventories". IAS 2 requires inventories to be measured at the lower of cost and net realizable value (NRV).

3. RECOGNITION OF THE INVESTMENT PROPERTY

Once the immovable property is classified as the investment property, it should be recognized as an object of accounting and reflected respectively in the financial statements.

The Standard offers the criteria of recognition of the assets as the investment property, which correspond factually the criteria of recognition of the assets, in general.

The Investment property should be recognized as an asset when:

It is probable that the future economic benefits that are associated with the property will flow to the entity, and the cost of the property can be reliably measured. The investment property is to be recognized as the assets in the cases, if:

- a) It is probable that the future economic benefits will flow to the entity; and
- b) The cost of the investment property can be reliably measured.

An entity should recognize the expenses borne for all investment property upon bearing thereof. These expenses include the initial costs of purchase of the investment property and the costs borne for its rehabilitation and startup. At the same time, an entity does not recognize in the balance value of the investment property the costs for a daily maintenance of such the assets. These costs should have to be recognized in the profit or the loss, immediately upon their bearing. Such the costs cover mainly the expenses for repair and operation of the investment property.

The Standard singles out the moments, which enables us to determine whether the main assets are necessary to be accounted as the investment property.

For example:

- The company lets in lease its own building. The lease agreement envisages the costs of maintenance and operation of the building. These services form an insignificant part of the agreement, therefore, the company treats the building as the investment property.
- The company owns a hotel, which is managed by the company itself - providing the rooms to the guests, etc. The agreement envisages also rendering services to the guests and, such the services form a significant part of the agreement. In this case, the hotel is not an investment property, but the main asset.

4. MEASUREMENT OF THE INVESTMENT PROPERTY

Initial value of the investment property should be measured by the factual costs borne, which cover the expenses associated to purchase and bring it into the useful conditions.

At the initial stage, the purchased or own investment property must be measured at its cost

The cost of the purchased investment property covers the costs of purchase and of the legal services (if any, of course), as well as the dues for transfer of the property, and other costs of the deal.

The cost of the own investment property of the entity should include the start-up costs, or initial operating losses incurred before the investment property achieves the planned level of occupancy. Until the said date will come, the entity applies IAS 16: Property, Plant and Equipment", while thereafter, the above mentioned property is transformed into the investment property and, IAS 40 starts operation.

For example, In March, 2016, the company purchased a land plot at 23500 GEL. According to the expectations of the Company, after three years when a sporting facilities will have been built on this land area, a value of the land will be increased considerably and, may be sold at several times higher price. The company paid 1500 GEL for the legal transaction. The costs incurred by the company are compensated in full.

Taking into consideration the company's intention to sell the property after three years when the sporting facility will have been built on the site, the property is to be treated as the property used (purchased) for the purposes of increase of the Company's capital.

The value of the investment property is as follows:

Indicators	Amount \$
Sum of the investment property-related transaction (Price of the Agreement)	23 500
Costs of the legal services	1 500
Cost of the investment property	25 000

Table 1. Determination of value of the investment property

In the event where by the agreed terms and conditions of the contract between the partners, payment of the price of the investment property is postponed for a certain period, the value of such investment property is to be calculated by equivalent of the amount which should have to be paid at the date of purchase. A difference between this amount and the total sum due, should be recognized as the interest-related expenses incurred during the period of credit.

Initial price of the investment property cannot be changed except for the following cases:

- 1) Reconstruction (modernization, rehabilitation) of the investment property and other similar works;
- 2) Revaluation of the investment property in pursuance with the country's legislation)

For measuring the investment property after its initial recognition, an entity must select as the accounting policy the fair value model or the cost model and, follow this policy for all the whole investment property the

IFRS 13 determines that the investment property must be measured at its fair value for each reporting date and, the changes should be reflected in the Profit and Loss Accounts of the relevant reporting period. Taking into consideration that in some countries the market of the investment property is not developed and, determination of the fair value is problematic, IAS allows that an entity may measure a value of the investment property using the "Cost Model" introduced in IAS 16.

An entity, which selects the Cost Model after the initial recognition, must measure its whole investment property at cost thereof, which will be reduced by the accumulated depreciation and the amount of a damage caused by the accumulated depreciation, except for the case where a reliable measurement of a fair value of the investment property is impossible. It happens where the comparable market deals are of a rare nature and, the fair value cannot be measured through the alternative ways (discount of the expected money flows).

In the last case, an entity must measure a value of the investment property using the Cost Model. Here, a remaining value of the investment property is deemed equal to zero. A fair value of the investment property reflects the market situation at the end of the relevant reporting period, while the profit or loss caused by change of the fair value should be treated as the profit or loss of the same reporting period.

According to the opponents of the fair value model, the model is non-practical, since there is often no active market for investment property. Real estate operations are rare and unmatched. In many cases the market is small or there is no well-established profession of evaluator. Every investment property is unique and every sale is implemented after the important negotiations. As a result, the fair value measurement does not increase the comparison, since the fair value is not determined on a reliable basis, especially in countries where the valuation profession is less well established. Measurement by the cost reduced by depreciation, provides a more reliable, less variable and less subjective assessment. The cost base is used for more "short-term" assets (such as commodity-material values)

for which the fair value is more relevant than the "investment" assets and, the costs of measurement by fair value are much higher than the benefit of the consumer.

In the explanatory notes to their financial statements, the entities should determine, which model; they use for accounting the investment property – Cost Model or Fair Value Model; In case of application of the Fair Value model, they must explain, how and when an operational lease is classified as the investment property.

The information on the fair value of the investment property and on changes therein, is very actual for the users of the financial reporting, since it enables them to understand it clearly.

According to the Standard, there existed a certain viewpoint that only those entities should be given a right of use of IAS 40, which are specialized in holding the investment property. Such the view was based on a factor that the reporting segment-related approach requires from the entities acceptance of the fair value model in cases where an enterprise treats its investment property transactions as an important part of its financial activity. In other cases, the standard allows the entities to apply IAS 16. However, this is not conceptual and practical way, of course, for making an exact difference between the groups and classes of entities for which the fair value model could be more or less relevant. At the same time, the reporting segment-related approach causes a lack of comparison of the investment property in the investment property segments and the investment property of other segments. Therefore, the above mentioned viewpoint is rejected.

Besides, it should be noted that some financial institutions consider the property occupied by its owner as an inseparable part of his/her investment portfolio and, in terms of management, treat it as the same sphere as the property let in lease. In case of the insurance property, this property may be held for performing the obligations of a holder of the insurance policy, i.e. the properties used for one and the same purposes, should be accounted in one and the same manner and, correspondingly, none of the classes of entities must use the fair value model for the property occupied by them. As to classification of hotels and similar properties, this approach is controversial, since the hotels, to certain extent, are treated as the investment while according to an alternative view, they are the operational property. In such a situation, it seems necessary to establish a detailed rule, of when and in which cases the hotels, as well as the property of other type, e.g. restaurants, bars, resting houses, etc., must be treated as the investment property or a property occupied by its holder. Proceeding from the factor that determination of incidental rules for special classes of the property is related with certain difficulties and, an exact identification of such single classes, which must be subordinated to such rules, is also difficult, it would be better to make a difference between the investment property and the property occupied by its owner on the basis of general principle.

In the event of changes in use of the property, a holder may re-classify its assets into the investment property or vice versa:

- a) With starting improvement of the property for its sale, and transformation of the investment property into the category of the commodity-and-material value;
- b) With completion of occupation of the property by its owner, for transforming the occupied property into the category of the investment property.
- c) With starting an operational lease with other parties, for transforming the property from the category of the commodity-and-material value into the category of the investment property.

According to IAS 40, when the property accounted by its fair value is turned into the property occupied by its owner, or into the commodity-and-material value, in such the cases, as provided by IAS 16 and IAS 2, a value of the property is its fair value as at the date of change in the use of this property.

After the initial recognition of the investment property, the latter is measured with its fair value, while the changes in the fair value are to be recognized in the profit-and-loss reporting. This rule of accounting differs principally from the accounting of the revaluated price of the property, plant and

equipment. According to IAS 16, such the difference belongs to the capital - "Inventories reserve" with bypassing the profit and loss.

For example, a balance value of a building was 5 MIO USD. After revaluation, the price of the building, which was classified as the investment property, increased from 5 MIO USD to 6 MIO USD. This operation must be reflected as follows:

Debit: Investment property 1 000 000

Credit: Other nonoperational revenues 1 000 000

5. IMPAIRMENT OF THE INVESTMENT PROPERTY

Towards each object of the investment property accounted by the cost method, the same requirements are applied as envisaged by IAS 16. Namely, such the objects are to be accounted in the financial statements with their cost minus the accumulated depreciation and a sum of the accumulated impairment

At the end of the relevant reporting period, at the date of composing the balance, an entity must determine whether there is any sign of impairment of the investment property and if so, the investment property must be accounted according to IAS 16.

Signs of impairment of the investment property are as follows:

- Important decrease of the current market value of the investment property;
- Increase of the market interest rate;
- Physical damage of the investment property;
- Significant changes in the economic environment where an entity is operating;
- Other signs of impairment of the investment property.

If the balance value of the property exceeds the recoverable value, the asset is treated as impaired.

A recoverable value is determined by a higher amount between the fair value and the disposal value, minus expenses of sale of the asset or the money generating object.

According to IAS 36, when calculating the operational value, the following items should be taken into account:

- a) Measurement of the future money flows to be received as a result of permanent use of the asset and its completion;
- b) Use of a relevant rate of discount towards the future money flows;

Measurement of the future money flows should include: forecasting a receipt of money sources in terms of their permanent use as well as forecasting the issuances of those money sources which are necessary for receiving the money flows as a result of permanent use if the given asset.

For example, revenues of an entity received by lease of the building, which was recognized as the investment property, in March, 2015, decreased by 30% in comparison with the same month of the previous year. This indicates on impairment of the investment property.

The initial value (cost) of the building makes 450 000 GEL, the accumulated amortization – 150 000 GEL, the balance value – 300 000 GEL (450 000 – 150 000). The current market value of the building minus the costs of realization makes 250 000 GEL.

The expected money flows of the investment property for the next three years, makes 100 000 GEL. The market interest rate is 20%

Let's now calculate a discounted value of the money flows to be received in future from the lease of the building:

Year 1 – $100\,000 / (1+0.2) = 83\,033$

Year 2 – $100\,000 / (1+0.2)(1+0.2) = 69\,444$

Year 3 - $100\,000 / (1+0.2)(1+0.2)(1+0.2) = 57\,870$

Total: 210 647

A higher of the market value of the investment property and the discounted value of the future money flows is a compensating value. In our case, the compensating value equals to 250 000 GEL ($250\,000 > 210\,647$)

CONCLUSION

Thus, the information on the fair value of the investment property and on changes therein, is essential for the users of the financial reporting, since a generation of money flows through the investment property by a company, takes place independently from other assets.

In the course of research of the above issue, some flaws were revealed, which are not regulated by the international standards. Namely, the Standard indicates that transfers to, or from, investment property should only be made when there is a change in use, evidenced by a proof of a purpose, but, the Standard does not provide, how a company can substantiate what the proof of purpose implies specifically. And, whether only a decision of a company is sufficient for changing the accounting. Noteworthy also, whether the requirements of the Standard correspond to the requirements introduced in practice for classifying a property as the investment property and those variable factors, which exist in conditions of the contemporary market

The Standard indicates also that it is better to make a difference between the investment property and the property occupied by its owner on the basis of general principles, rather than on the grounds of existence of incidental rules for specific classes of the property. However, the Standard indicates also that an exact identification of specific classes of the property is difficult. The Standard does not explain what the general principles imply. Besides, in certain cases, an entity renders services to those persons, who occupy its own property. In such a case, the entity treats this property as the investment property, provided that the above mentioned services form an insignificant part of an agreement between the parties. However, the Standard does not explain a size of the “insignificant part”.

The main difficulty when measuring the investment property is an adequate measurement of the fair value that should be performed by a professional valuator. However, in practice, measurement of the fair value is certainly difficult, if taking into consideration the fact that the methods of measurement should justify the auditor’s report issued for financial reporting of a company.

In our view, application of the fair value model for the countries with weakly developed market, creates certain precondition for further development of the markets of such type, and also for development of the profession of valuator.

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