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What you need to know about International Financial Reporting Standards (IFRS)

In this issue of **debrief**, we are keeping you informed of the key property issues and implications of new accounting standards linked to IFRS. Some companies have already reported under IFRS, but as there are no case law precedents, the full implications are still a long way from being known.

Of the 37 accounting standards which fall under IFRS, three are of particular importance to property. For UK companies with real property assets, the equivalent IFRS/IAS and United Kingdom Generally Accepted Accounting Practices (UK GAAP) regulations are:

UK GAAP

FRS15 (tangible fixed assets)
SSAP21 (accounting for leases)
SSAP19 (investment properties)

IFRS

IAS16 (property, plant and equipment)
IAS17 (leases)
IAS40 (investment property)

The main changes introduced under these new regulations on property are:

- the move to Fair Value for investment property
- companies will be allowed to carry historic cost over on owner-occupied properties
- a revaluation to Fair Value of any new business acquisition is now required (**IFRS3**)
- there are new rules for the treatment of leases

As a reminder

Under EU Regulation No. 1606/2002 of the European Parliament and Council, all companies listed on any European Stock Exchange are required to report under IFRS for their financial year beginning on or after **1 January 2005**. Under current Government proposals, a **two-year convergence period** from UK GAAP to IFRS has been given for non-listed companies. Gerald Eve is already providing strategic advice on this matter to our clients, and will ensure we keep you up-to-date on on-going developments.

A handwritten signature in black ink, appearing to read 'Richard Moir'.

Richard Moir
Partner

A handwritten signature in black ink, appearing to read 'Simon Brand'.

Simon Brand
Partner

Impact of IFRS on Property Accounting

The impact of IFRS will vary between different European countries, yet the new rules have more in common with UK GAAP than elsewhere. Although these similarities exist in the UK, as yet there is no 'international GAAP', and certain issues are being looked at afresh to ensure that accounts are being prepared on the correct basis.

IFRS	Valuation Method
IAS16	→ property, plant and equipment measured at depreciated cost or up-to-date fair value
IAS17	→ different rules apply to different lease types
IAS40	{ cost model – measured at depreciated cost, with fair value disclosed in notes or fair value model – valuation of fair market value

For many jurisdictions, the crucial innovation is the requirement to account for investment property using the Fair Value model, rather than on a cost basis. Even though cost accounting is a permitted treatment of investment property, IFRS requires the disclosure of the Fair Value figures as well.

Reporting Fair Value

For investment property (property held for capital appreciation, rent, or both), the preferred treatment is to report current values in financial statements, expressed as Fair Value. The alternative cost accounting approach is still permitted, but only if the Fair Value figures are disclosed in the financial statements that accompany the cost accounting approach. The cost accounting alternative is not permitted if leasehold property is classified as investment property.

Either way, up to date valuations will be required of all investment property, as is normally done already in the UK.

Leasehold property as an investment

IFRS now permits leasehold property to be treated as investment property (as was the case under UK GAAP) but only if the asset is accounted for as if it were held under a finance lease, and is valued to Fair Value.

Reporting in profit & loss account

Investment property reported under the Fair Value model, under IAS40, will have the revaluation gains and losses transferred directly to the profit & loss account (unless they reverse previous losses that have been shown against equity). At present under UK GAAP these are shown in the Statement of Total Recognised Gains and Losses (STRGL) but not in the profit & loss account.

Owner Occupied Property

Cost accounting or Fair Value accounting

IAS16 permits, but does not require, Fair Value accounting for owner-occupied property. Cost accounting is also permitted and there is no requirement to disclose Fair Value figures for operational assets, although this is encouraged. However, following any business combination assets must be recognised initially at Fair Value.

Should companies choose to adopt the Fair Value model, then any revaluation gains and losses are transferred to equity under the revaluation reserve, not the profit & loss account.

Demise of Existing Use Value (EUV)

EUV evolved over many years to correspond with the requirements under UK GAAP and FRS15 to report an appropriate value for an asset assuming the company will continue to use it (as opposed to a break up value), and therefore emphasises the replacement cost of the utility of the asset.

The IVSC does not have an equivalent definition, and therefore has equated Fair Value under IAS16 (and elsewhere) with Market Value (MV) under International Valuation Standards (IVS). Potentially, this could lead to some uncertainty on the basis of valuation being reported in company accounts. It is

Main Changes for UK Companies

Same figures, different presentation

The sample calculation below reflects the commercial company that leases the property that it uses in its business. The example shows the position at the inception of a lease. Operating leases are not capitalised in the tenant's accounts. But if a lease is a finance lease, the tenant must show the lease as an asset and show as a corresponding liability the present value of the payments they are committed to make over the lease term. As you can see, the change in accounting standards results in a significant variation in borrowing as a percentage of gross assets ie gearing.

Balance sheet

UK GAAP:

Fixed asset register	£m	£m
Land and property	n/a	
Plant and equipment	40	
Fixed assets:		40
Current assets	38	
Current liabilities (inc £10m overdraft)	(17)	
Net current assets:		21
Total assets less current liabilities:		61
Term loans	(20)	
Present value of lease commitments	n/a	
Long term liabilities:		(20)
Net assets:		41

Gearing: borrowings as % of gross assets: 38.5%

IFRS:

Fixed asset register	£m	£m
Land and property	50	
Plant and equipment	40	
Fixed assets:		90
Current assets	38	
Current liabilities (inc £10m overdraft)	(17)	
Net current assets:		21
Total assets less current liabilities:		111
Term loans	(20)	
Present value of lease commitments	(50)	
Long term liabilities:		(70)
Net assets:		41

Gearing: borrowings as % of gross assets: 62.5%

clear from IAS16 that Depreciated Replacement Cost (DRC) is a permitted technique for Fair Value accounting, and therefore the IVSC have included DRC within their permitted techniques to arrive at Market Value.

Many in the valuation profession are unhappy with this change, as they consider an explicit distinction needs to be made (as per FRS15) between those properties reported using market price evidence, and those where the value has been derived indirectly from non-transactional sources. To a large extent this problem will be resolved by the increasing reporting requirements under IAS16. If followed to the letter, the disclosures required under IAS16 will set the property valuation in context, and reveal the extent to which they have been adduced using market evidence or more indirect techniques.

Moving from EUV to IFRS

Those companies who have previously reported EUV values in their accounts will not necessarily have to do a complete revaluation. In many cases EUV is the same as Market Value. In those uncommon cases where there is a difference, companies will need to decide how to present their asset values under IFRS.

Under IFRS1 (First Time Adoption of International Financial Reporting Standards), the use of an EUV valuation as a basis for a cost accounting approach under IFRS should be within the terms of the Standard. It is no longer permitted to refer to historic valuations.

Leaseholds

Accounting for a finance lease

The change in accounting for leasehold assets is one area where problems can arise. As under UK GAAP, the distinction between an operating and a finance lease remains, but the definition of a finance lease has been changed. This could lead to certain assets needing to be reclassified in company accounts.

A finance lease is now classified as a lease that transfers substantially the risks and rewards of ownership to the lessee. Although there are value tests implicit in the Standard, the 90% rule written into SSAP21 is not repeated.

If a lease is classified as a finance lease, then the lessee is deemed to own the asset and the lessor to have sold it for a deferred payment. The asset and liability attached to that lease are shown separately in the accounts of the lessee, with the asset figure subject to Fair Value revision (depending on the policy adopted) but the liability figure is not adjusted. The rent paid under a finance lease has to be apportioned between a finance charge for the deferred payment for the asset, and a depreciation charge to pay off the capital value of the asset. In terms of real property, such a distinction seems artificial. The effect of this is that lease liabilities will appear on the balance sheet and affect the gearing calculation of the company, possibly impinging on banking covenants.

Dealing with lease ownership

Finance leases will be treated as the property of the lessee. Operating leases will always be treated as the property of the lessor. There is no requirement that lessees and lessors agree on the classification of the same asset. Further provisions govern the reporting of any departure from the underlying Market Value of an asset brought about by the introduction of a sale and leaseback transaction.

Separation of land and buildings

Land and buildings are treated separately for the purposes of lease classification and may be reported as separate assets. Land, having an indefinite economic life, is considered to be an operating lease in every case. The buildings may be an operating or a finance lease depending on the specific criteria. It is possible that a company may hold a lease with the building considered as a finance lease, and the land treated separately as an operating lease. Both the lease classification and its subsequent treatment (if the buildings are a finance lease) will require an accurate and reliable apportionment of the asset between the land and buildings.

Classification of leases for financial reporting

The implication of these rules is that all listed companies with leased property assets need to review their lease classification for the purposes of financial reporting. In the majority of cases this will be a straightforward exercise but advice may be required on borderline cases.

Property	IFRS
Owner-occupied	
Freehold	→ IAS16
Leasehold	→ IAS17
Property being developed /under construction	→ IAS16
Investment property	{ IAS16 (cost model with notes accounted for under IAS40) or IAS40 (fair value model)

Gerald Eve is well equipped to assist with classification of leases, and we have recently advised The Restaurant Group on this matter. Please contact Richard Moir, Simon Brand or your usual partner for further information on this or any other property issues arising under IFRS.

Reporting ongoing liability

Another change for leasehold accounting is that operating lease liabilities will have to be revealed in much more detail than under UK GAAP. Liabilities for rent outgoings on non-cancellable leases will have to be shown for the next year, the period up to five years, and periods longer than five years. This will give the readers of accounts better information on the ongoing liability assumed by companies.

Other Features of IFRS

Future changes for non-listed companies

Under the general convergence project, the Accounting Standards Board (ASB) is reviewing those standards that will remain in application for non-listed companies in the UK who have not elected to adopt IFRS. The disclosure of lease liabilities is likely to be one of the amendments made.

Other standards affecting property assets

The valuation of property assets and their treatment will also occur under other IFRS standards. These include:

IAS12 (income taxes) requires companies to provide for deferred income tax on all revaluation surpluses;

IFRS3 (business combinations) requires the assets of acquired companies to be declared at Fair Value;

IAS 2 (inventories) deals with properties held and traded in the normal course of the business.

Leading our sector, not following it

“ **We believe technical expertise should come as standard with any property consultancy. What sets us apart is our role in driving change and influencing policy. Many of our partners are at the top of their profession, playing influential roles in advising Government and guiding clients through change.** ”

Here at Gerald Eve, we strive to be leaders in our field and to pass on the many benefits of our creative approach to you, our clients and friends.

debrief is just one of the many ways we communicate the key issues in our swiftly-changing property world.

International Financial Reporting Standards. The 2005 Rating Revaluation. Reforms to the Landlord and Tenant Act 1954. The Planning and Compulsory Purchase Act 2004. All these and more have seen input from our specialists.

Key Gerald Eve personnel — people like Richard Moir, Hugh Bullock, Graham Foster and Jerry Schurder — all play a role in advising on legislative, statutory and regulatory changes. It's that involvement that keeps our clients ahead of the game on issues that directly affect their interests. We are at the vanguard of our sector and believe our leadership can only be of benefit to our clients.

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David Butters, Senior Partner

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