CHAPTER 16

INVESTMENT PROPERTY

1. BACKGROUND

In accordance with the international trend toward fair value accounting in financial accounting, IAS 40 Investment Property favours accounting for investment properties using the fair value model. However, IAS 40 still allows investment properties to be accounted for at depreciated historic cost provided that fair values are disclosed (some exceptions apply).

The definition and the recognition criteria of investment property are consistent with the definition and recognition of an asset found in the Framework and builds on the Framework to refine the concepts so as to apply to them to investment property.

Although investment property is initially measured at cost, an entity then chooses one of the following accounting policies for accounting for its investment properties:
- fair value model: Investment property is measured at fair value (some exceptions apply); or
- cost model: Investment property is measured at depreciated historic cost.

Although a free choice is available between the fair value model and the cost model, IAS 40 expresses a preference for the fair value model as it states that it is highly unlikely that the cost model will result in more relevant presentation. This effectively prohibits a subsequent change in accounting policy from the fair value model to the cost model.

Included in the ambit of IAS 40 is investment property held by the reporting lessee under a finance lease. This inclusion is also extended to property held under operating leases on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property is accounted for under the fair value model (i.e. this includes all owned investment property). The fair value of investment property held under a long-term lease is determined with reference to the rights given by the lease. The obligations under the lease should be accounted for as a liability.

2. DEFINITIONS

Investment property is defined (paragraph 5) as property (land or buildings – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation (or both). Investment property, therefore, is neither:
- held for use in production or supply of goods or services or for administrative purposes, nor
- held for sale in the ordinary course of business.

Examples of investment property:

Land held for long-term capital appreciation is an investment property.

Land held for an undetermined use is specifically included in investment property. For example, an entity acquires land upon which it may erect its administrative headquarters in a few years time or it may hold the land for capital appreciation, but if someone makes an unsolicited offer to purchase the land at a price well in excess of what the company thinks it is worth, then the entity would dispose of it in the short term. Such land is investment property.
A building owned by the entity (or held under a finance lease) and leased out under one or more operating leases is investment property.

A building that is vacant, but is held to be leased out under one or more operating leases, is an investment property.

A property that is being constructed or developed for future use as investment property is investment property.

**Owner-occupied property**

IAS 40 paragraph 5 defines *owner-occupied property* as property held by the owner (including the lessee under a finance lease) for use in the production or supply of goods or services, or for administrative purposes.

Owner-occupied property is not investment property, and accordingly is accounted for as property, plant and equipment in accordance with IAS 16 (see Chapter 15). Owner-occupied buildings are therefore, in accordance with the reporting entity’s accounting policy for buildings (property, plant and equipment), either carried at depreciated historic cost (the cost model) or depreciated revalued amount (the revaluation model).

Owner-occupied property includes:

- property held for future use as owner-occupied property,
- property held for future development and subsequent use as owner-occupied property,
- property occupied by employees of the reporting entity (even if the employees pay market related rentals under operating leases), and
- owner-occupied property awaiting disposal.

Where the owner occupies a portion of property that is held to earn rentals under operating leases, the following ‘rules’ (some of which require carefully considered judgement) must be applied:

- where the owner-occupied section could be sold separately to the section that is rented out, then the sections are accounted for separately (i.e. the section occupied by the owner is accounted for as property, plant and equipment and the externally rented section is accounted for as an investment property);
- where the sections cannot be sold separately and only an insignificant section is occupied by the owner, then the entire property is accounted for as an investment property; and
- where the sections cannot be sold separately and the owner occupies a significant section, then the entire building is accounted for as property, plant and equipment.

Where the reporting owner provides ancillary services to the occupants of its property, the following rules (some of which require carefully considered judgement) must be applied:

- where the services are a relatively insignificant component of the arrangement as a whole, then the property is accounted for as an investment property in accordance with IAS 40; and
- where the services are a more significant component of the arrangement as a whole, then the property is accounted for as property, plant and equipment in accordance with IAS 16.

IAS 40 (paragraph 13) acknowledges that it may, in certain circumstances (as discussed above), be difficult to differentiate investment property from property, plant and equipment. Accordingly, IAS 40 (paragraph 14) requires the reporting entity to develop criteria to ensure that it consistently exercises its judgement. For example, an entity may decide that occupation of 1% or less of the total floor area of a building constitutes an insignificant occupation. In applying this ‘rule’, all dual-purpose buildings in which the reporting owner occupies less than 1% of the total floor are classified as investment property.

Where a subsidiary company occupies its parent company’s investment property, the parent would account for the property as follows:

- as an investment property in its company financial statements, and
• as an owner-occupied property in its consolidated financial statements.

3. RECOGNITION AND MEASUREMENT

3.1 Initial recognition

Paragraph 16 requires an investment property to be recognised as an asset when, and only when:
• it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and
• the cost of the investment property can be measured reliably.

3.2 Initial measurement of investment property

Investment property is initially measured at cost, including:
• the purchase price (or the equivalent cash cost where payment is deferred), and any 
• directly attributable expenditure (e.g. legal fees, transfer duty, and other transaction costs).

The cost of self-constructed investment properties excludes:
• abnormal wastage of material, labour and other resources incurred in constructing the property;
• start-up costs (unless they are necessary to bring the property to its working condition); and
• initial operating losses incurred before the investment property achieves break-even occupancy.

Illustrative example 16.1: Initial recognition and measurement
On 1 January 20.1, Wise Limited acquired an investment property for R11 million. The purchase agreement provided for settlement in full on 31 December 20.1 (an appropriate discount factor is 10%). R1 million transfer duty and R20 000 legal fees were incurred and paid during January 20.1 in respect of the acquisition of this property. Rates for the year ended 31 December 20.1 of R100 000, were paid on 30 November 20.1. All amounts given are exclusive of value added tax.

During 20.1, Wise Limited constructed an investment property, expenditure on which is detailed below:
• Labour: R2 million (R200 000 of which was incurred due to restore faulty work performed by ‘scab’ labourers whilst the company’s employees were on strike and a further R100 000 was in respect of unproductive time whilst waiting for the foundations to dry);
• Materials: R8 million (R1 000 000 of which was incurred to restore faulty work performed by ‘scab’ labourers whilst the company’s employees were on strike and an estimated further R500 000 in normal wastage).
• Other resources: R2 000 000.

Wise Limited completed the self-constructed building on 30 November 20.1 and made an operating loss on this investment property of R500 000 (due to low initial occupancies) for the month of December 20.1. It is anticipated that this investment property will reach break-even occupancy during August 20.2, and the total budgeted operating loss to that date is estimated to be R2 million.

Required:
Calculate the cost of each of the investment properties to be recognised by Wise Limited upon initial recognition of the investment properties.
### Solution:

**Purchased property:**

<table>
<thead>
<tr>
<th>Reasons and calculations:</th>
<th>Rand</th>
</tr>
</thead>
<tbody>
<tr>
<td>R11 000 000/1.1 discount factor</td>
<td>10 000 000</td>
</tr>
<tr>
<td>Given</td>
<td>1 000 000</td>
</tr>
<tr>
<td>Given</td>
<td>20 000</td>
</tr>
<tr>
<td>Operating cost therefore excluded</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>11 020 000</strong></td>
</tr>
</tbody>
</table>

**Self-constructed property:**

<table>
<thead>
<tr>
<th>Labour:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>abnormal reworking</td>
<td>Abnormal wastage</td>
</tr>
<tr>
<td>unproductive time whilst foundations drying</td>
<td>Normal wastage</td>
</tr>
<tr>
<td>remainder</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>R2 000 000 – R200 000 – R100 000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Materials:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>abnormal reworking</td>
<td>Abnormal wastage</td>
</tr>
<tr>
<td>normal wastage</td>
<td>Given</td>
</tr>
<tr>
<td>remainder</td>
<td>R8 000 000 – R1 000 000 – R500 000</td>
</tr>
<tr>
<td>Given</td>
<td>2 000 000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>An operating expense</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>10 800 000</strong></td>
</tr>
</tbody>
</table>

Note that budgeted operating losses will also be excluded.

Subsequent expenditure on an investment property is evaluated in terms of the initial recognition criteria:

- it is probable that future economic benefits that are associated with the investment property will flow to the entity; and
- the cost can be measured reliably.

Replacements are recognised if the recognition criteria are met and the part that is replaced is derecognised. All other subsequent expenditure (i.e. repairs and maintenance) is expensed in the period in which it is incurred.

**Illustrative example 16.2: Subsequent expenditure**

During 20.2, Wise Limited (see illustrative example above) made the following expenditures on the investment property that it has constructed itself during 20.1:

- R1 million on erecting shade-cloth covered parking for its tenants, in respect of which additional operating lease rentals of R25 per month per covered parking bay will be received;
- R3 million on tarring parking for an additional 200 customer parkings for the tenants customers, no additional rentals are to be received in respect of this expenditure;
- R400 000 on repairing the roof in respect of hail damage caused during 20.2 (as hail does not usually fall in the location of this building, this expenditure was totally unanticipated and failure to incur the expenditure would result in a substantial loss of future rental income);
- R2 million in property rates; and
- R200 000 legal fees on debt collection for ‘delinquent’ tenants.

**Required:**

Determine the amount that in accordance with IAS 40 must be:

- Capitalised to the investment property, and
- Expensed in arriving at operating profit for the year ended 31 December 20.2.
### Solution:

<table>
<thead>
<tr>
<th>Reason</th>
<th>Capitalise</th>
<th>Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shade-cloth covered parking</td>
<td>Future economic benefits (operating lease rentals)</td>
<td>Rand 1 000 000</td>
</tr>
<tr>
<td>Tarred parking for lessee’s customers</td>
<td>No future economic benefits for Wise Limited</td>
<td>Rand 3 000 000</td>
</tr>
<tr>
<td>Repairs to hail damaged roof</td>
<td>The restoration will lead to future economic benefits</td>
<td>Rand 400 000</td>
</tr>
<tr>
<td>Property rates</td>
<td>Operating expense</td>
<td>Rand 2 000 000</td>
</tr>
<tr>
<td>Legal fees</td>
<td>Operating expense</td>
<td>Rand 200 000</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

### 3.3 Subsequent measurement of investment property

An entity must choose (paragraph 30) one of the following accounting policies for accounting for its investment properties:

- **fair value model**: Investment property is measured at fair value except in the exceptional circumstances where there is clear evidence at the date of acquisition that fair value will not be reliably measurable on a continuing basis in which case such investment property is carried at depreciated historic cost computed to a nil residual value; or
- **cost model**: Investment property is measured at depreciated historic cost.

Although a free choice is available between the fair value model and the cost model, IAS 40 expresses a preference for the fair value model as it states that it is highly unlikely that the cost model will result in more relevant presentation (paragraph 31). This effectively prohibits a subsequent change in accounting policy from the fair value model to the cost model.

An entity may choose the fair value model or the 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 that investment property. Choosing the fair value model for this category of investment property does not preclude the entity from choosing the cost model in respect of its other investment properties (paragraph 32A).

#### 3.3.1 The fair value model

Subsequent to initial recognition, an entity that uses the fair value model, measures all of its investment property at fair value.

**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See Chapter 3 which covers IFRS 13 *Fair Value Measurement*.)

Paragraph 32 encourages (but does not require) that investment property valuations be performed by an independent suitably qualified valuer who has recent experience in the location and category (e.g. commercial, industrial or residential) of the investment property being valued.

Changes in the fair value of investment properties during an accounting period are included in the determination of the profit (or loss) for that period.
Paragraph 50 of IAS 40 provides that where the fair value model is adopted, care must be exercised to avoid the double counting of assets or liabilities that are recognised in the statement of financial position as separate assets and liabilities. Therefore:

- equipment that is an integral part of the investment property (e.g. elevators, escalators, ducted air-conditioners and under-floor-heating-systems) shall not be recognised separately (i.e. they are recognised in the fair value of the investment property),
- where offices are leased out on a furnished basis, then the furniture shall not be recognised separately from the fair value of the investment property,
- the fair value of investment property excludes prepaid or accrued operating lease income, as the entity recognises it as a separate liability or asset respectively, and
- the fair value of investment property held under a lease reflects expected cash flows. Therefore if a valuation obtained for a property is net of all payments expected to be made, any recognised lease liability will need to be added back to arrive at the carrying amount of the investment property using the fair value model.

**Illustrative example 16.3: Determination of fair value**

During 20.3, Ripoff Limited built a three-storey fully furnished (furnishings cost R2 million) and ducted air-conditioned (air-conditioner cost R4 million) office building ‘The Pink Palace’ with a state-of-the-art Otis elevator (elevator cost R3 million). The total cost of constructing the building including the fittings mentioned was R25 million. The building was completed in July 20.3 and was immediately let out to twenty-five small-businesses under operating leases. The small businesses pay their rentals monthly in advance on the last day of the preceding month. Such prepaid rental amounted to R500 000 on 31 December 20.3.

Ripoff Limited applies the fair value model to account for its investment property. At 31 December 20.3, Verygood Valuers (Pty) Ltd valued the fully furnished office building at R30 million (after taking in account the prepaid rental of R500 000).

**Required:**

List, with brief reasons, the classification and amount at which each of the assets and liabilities determinable from the information provided shall be presented in Ripoff Limited’s statement of financial position at 31 December 20.3.

**Solution:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Reason</th>
<th>Classification</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Pink Palace</td>
<td>Fair value Para 50 (c) IAS 40</td>
<td>Investment property</td>
<td>30 500 000</td>
</tr>
<tr>
<td>Furnishings</td>
<td>Included in the investment property as is let out on a fully furnished basis</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Ducted air-conditioner</td>
<td>Included in the investment property as an integral part of the property</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Elevator</td>
<td>Included in the investment property as an integral part of the property</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Prepaid rentals</td>
<td>In respect of January 20.4</td>
<td>Current liability</td>
<td>500 000</td>
</tr>
</tbody>
</table>
3.3.2 Presentation and disclosure: Fair value model

Set out below are the presentation and disclosure requirements of IAS 40 where the reporting entity adopts the fair value model for investment properties.

Accounting policies note:
- the fact that investment properties are accounted for under the fair value model,
- whether and in what circumstances property interests held under operating leases are classified and accounted for as investment property, and
- the criteria used to distinguish investment property from owner-occupied property and property held as inventory.

Note to investment properties (non-current asset):
A reconciliation of the carrying amount of investment property at the beginning and end of the period showing:
- additions showing separately acquisitions and capitalised subsequent expenditure,
- additions from business combinations,
- assets classified as held for sale or included in a disposal group classified as held for sale and other disposals,
- net gains or losses from fair value adjustments,
- net exchange differences arising from the translation of foreign entities,
- transfers to and from inventories and owner-occupied property, and
- other movements.

The extent to which fair value has been valued by an independent suitably qualified valuer who has recent experience in the location and category of investment property being valued, or where there has been no such valuation, a statement of that fact.

Any restrictions on the realisability of the investment property or the remittance of income and proceeds of disposal (that fact and the amounts to be disclosed).

When a valuation is adjusted significantly for the purpose of the financial statements, the entity shall disclose a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements showing separately the aggregate amount of any recognised lease obligations that have been added back, and any other significant adjustments.

Note to contractual commitments:
- Contractual obligations to purchase, construct, develop, repair, maintain or enhance investment properties.

Note to profit from operations:
The amounts included in profit or loss in respect of investment property, for:
- rental income,
- direct operating expenses (e.g. repairs and maintenance) analysed between properties that generated rental income and those that did not, and
- the cumulative change in fair value on a sale of investment property from a pool of assets in which the cost model is used into a pool in which the fair value model is used.

The above disclosures are in addition to any prescribed by IAS 17 Leases if applicable.
3.3.3 Where the fair value model is adopted and the fair value of a particular investment property cannot be measured on a continuing basis

There is a rebuttable presumption that an entity will be able to measure the fair value of an investment property reliably on a continuing basis. However, in exceptional circumstances where at the date of acquisition (or when an existing property first becomes investment property after a change in use) the fair value of the investment property is not considered to be measurable on a continuing basis and the entity applies the fair value model, it will account for affected investment property (until the disposal thereof) at its depreciated historic cost computed to a residual value of zero (all other investment property, including investment property under construction, will continue to be accounted for on the fair value model). However, where only subsequent to initial recognition it is established that fair value cannot be measured on a continuing basis, the investment property is continued to be carried at its fair value.

With regards to an investment property under construction or development, if the entity determines that the fair value of an investment property under construction is not reliably measurable but expects the fair value to be reliably measurable when construction is completed, the entity measures the investment property under construction at cost until either its fair value becomes reliably measurable or construction is complete (whichever is earlier).

Paragraph 53A explains that once an entity becomes able to measure reliably the fair value of an investment property under construction that has previously been measured at cost, it shall measure that property at its fair value. Once construction is complete, it is presumed that the fair value can be measured reliably, and if this is not the case, then the property must be accounted for using the cost model in accordance with IAS16.

Note that the presumption that the fair value of an investment property under construction can be measured reliably can be rebutted only on initial recognition. An entity that has measured an item of investment property under construction at fair value may not conclude that the fair value of the completed investment property cannot be measured reliably.

The following disclosures apply where, at the date of acquisition of an investment property, the reporting entity considered that it would not be able to measure the fair value of an investment property reliably on a continuing basis:

A reconciliation of the carrying amount of investment property at the beginning and end of the period, presented separately for:

- property carried at fair value, and
- property carried at cost (as a result of fair value not being reliably measured on a continuing basis from the date of acquisition):
  - additions showing separately acquisitions and capitalised subsequent expenditure,
  - additions from business combinations,
  - assets classified as held for sale or included in a disposal group classified as held for sale and other disposals,
  - net gains or losses from fair value adjustments,
  - net exchange differences arising from the translation of foreign entities,
  - transfers to and from inventories and owner-occupied property, and
  - other movements.
In respect of the investment property identified in paragraph 53 only (that is carried at depreciated historic cost), the following is to be disclosed:

- a description of the investment property,
- an explanation of why fair value cannot be reliably measured,
- if possible, the range of estimates within which fair value is highly likely to lie, and
- on disposal:
  - the fact that the entity has disposed of investment property not carried at fair value,
  - the carrying amount of that investment property at the time of disposal, and
  - the amount of the gain or loss recognised.

If an entity has previously measured an investment property at fair value, it continues to measure the property at fair value until disposal (or until the property becomes owner-occupied or the entity begins to develop the property for sale in the ordinary course of business) even if comparable market transactions become less frequent or market prices become less readily available (paragraph 55).

3.3.4 The cost model

Under the cost model, investment property is measured using IAS 16 – Property, plant and equipment’s benchmark accounting treatment (i.e. depreciated historic cost).

It is emphasised that owner-occupied property does not constitute investment property and accordingly, such property is accounted for in its entirety in accordance with IAS 16 – Property, plant and equipment.

3.3.5 Presentation and disclosure: Cost model

The presentation and disclosure of investment property that is accounted for on the cost model, is prescribed by IAS 40 – Investment property (i.e. it is only the measurement that is accounted for in accordance with IAS 16). The presentation and disclosure requirements of IAS 40 in respect of investment properties accounted for on the cost model are set out below.

Note to investment properties (non-current asset):
The gross carrying amount and the accumulated depreciation (including accumulated impairments) at the beginning and at the end of the period.

A reconciliation of the carrying amount of investment property at the beginning and end of the period showing:

- additions showing separately acquisitions and capitalised subsequent expenditure,
- additions from business combinations,
- assets classified as held for sale or included in a disposal group classified as held for sale and other disposals,
- depreciation,
- impairment losses recognised or reversed,
- net exchange differences arising from the translation of foreign entities,
- transfers to and from inventories and owner-occupied property, and
- other movements.

The fair value of the investment property. In exceptional circumstances (paragraph 53) where the fair value cannot be measured reliably, the entity shall disclose:

- a description of the investment property,
- an explanation of why the fair value cannot be measured reliably, and
- if possible, the range of estimates within which fair value is likely to lie.
The extent to which fair value has been valued by an independent suitably qualified valuer who has recent experience in the location and category of investment property being valued, or where there has been no such valuation, a statement of that fact.

Any restrictions on the realisability of the investment property or the remittance of income and proceeds of disposal (that fact and the amounts to be disclosed).

**Accounting policies note:**
- the fact that investment property is accounted for under the cost model,
- the criteria used to distinguish investment property from owner-occupied property and property held as inventory,
- the depreciation methods used, and
- the useful lives or the depreciation rates used.

**Note to profit from operations:**
The amounts recognised in profit or loss, in respect of investment property, for:
- rental income, and
- direct operating expenses (e.g. repairs and maintenance) analysed between properties that generated rental income and those that did not.

**Note to contractual commitments:**
Contractual obligations to purchase, construct, develop, improve or maintain investment properties.
Illustrative example 16.4: Contrasting the fair value model and the cost model

On 1 January 20.2, Pater Limited acquired 75% of the ordinary share capital of Sister Limited when Sister Limited’s only investment property (an office building situated in Sandton Gauteng) had a fair value of R10 million. Sister Limited’s investment property was constructed three years earlier at a cost of R7.6 million. The building is subject to a five-year operating lease in terms of which lease payments of R100 000 per month are receivable monthly in advance on the first day of the month.

On 1 January 20.2, Pater Limited had one investment property (an office building situated in Downtown Johannesburg) which it had constructed at a cost of R20 million on 1 January 20.0. Pater Limited immediately entered into an operating lease over this building. The two-year lease was entered into on 1 January 20.0, in terms of which lease rentals of R200 000 per month are receivable monthly in arrear on 31 December of each month. The tenant vacated the building on 31 December 20.1. In the face of difficult socio-economic conditions, the building was vacant for the duration of 20.2. However, on 1 January 20.3 a new tenant will take up occupation under a three-year operating lease with an option to renew for a further three-year period.

The fair value of the investment properties was established by an independent suitably qualified valuer with extensive experience in valuing office buildings in the same locations as those of the group’s properties as follows:

<table>
<thead>
<tr>
<th></th>
<th>Pater Limited</th>
<th>Sister Limited</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rand</td>
<td>Rand</td>
<td>Rand</td>
</tr>
<tr>
<td>1 January 20.2</td>
<td>25 000 000</td>
<td>10 000 000</td>
<td>35 000 000</td>
</tr>
<tr>
<td>31 December 20.2</td>
<td>8 000 000</td>
<td>30 000 000</td>
<td>38 000 000</td>
</tr>
</tbody>
</table>

The Sandton building was valued with reference to recent sale transactions of similar Sandton office buildings.

As there were no recent sales of similar buildings in Downtown Johannesburg, that building was valued other than by reference to a market (i.e. it was valued by projecting probable future operating lease rentals). R8 million is considered to be the recoverable amount of the investment property.

You are to assume that all buildings have a 20-year useful life with no residual value.

During 20.2, the following expenditures related to the investment properties:

<table>
<thead>
<tr>
<th></th>
<th>Pater Limited</th>
<th>Sister Limited</th>
</tr>
</thead>
<tbody>
<tr>
<td>repairs and maintenance</td>
<td>50 000</td>
<td>500 000</td>
</tr>
<tr>
<td>property rates</td>
<td>200 000</td>
<td>400 000</td>
</tr>
<tr>
<td>improvements completed on 31 December 20.2 (will result in R30 000 additional rent per month for the remaining portion of the lease)</td>
<td>-</td>
<td>2 500 000</td>
</tr>
</tbody>
</table>

Consider the following scenarios:

**Scenario 1:** The Pater Limited Group accounts for investment property on the *fair value* model.

**Scenario 2:** The Pater Limited Group accounts for investment property on the *cost* model.

**Required:** Prepare, in respect of investment property only, in columnar format for each of the scenarios presented above, The Pater Limited Group:

- Extracts from the statement of financial position (and notes thereto) at 31 December 20.2, and
- Extracts from the notes to the statement of comprehensive income for the year ended 31 December 20.2.

Comparative figures are not required.
Solution:

PATER LIMITED GROUP
STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20.2

<table>
<thead>
<tr>
<th>Note</th>
<th>Scenario 1: Fair value model</th>
<th>Scenario 2: Cost model</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Calculation:</td>
<td>Calculation:</td>
</tr>
<tr>
<td></td>
<td>R’000</td>
<td>R’000</td>
</tr>
<tr>
<td>ASSETS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment property</td>
<td>13</td>
<td>R8 mill (FV Pater) + R30 mill (FV Sister)</td>
</tr>
</tbody>
</table>

PATER LIMITED
NOTES TO THE FINANCIAL STATEMENTS
AT 31 DECEMBER 20.2

Note 1: Accounting policies
Investment property
Investment properties are land and buildings held by the group to earn rentals and/or for capital appreciation. Where the group occupies such property, it is classified as an owner-occupied property, and accounted for in accordance with the accounting policy for property, plant and equipment. Properties held for sale in the ordinary course of business are excluded from investment properties and are accounted for in accordance with the accounting policy for inventory.

Investment properties are initially recorded at cost including transaction costs. Subsequent measurement is at:

- **Scenario 1**: fair value with the adjustment for the period being included in the determination of profit or loss for that period.
- **Scenario 2**: depreciated historic cost with depreciation computed on the straight-line method to nil residual value over an estimated 20-year useful life of buildings. Land is not depreciated.
### PATER LIMITED GROUP
NOTES TO THE FINANCIAL STATEMENTS
AT 31 DECEMBER 20.2

#### Note 13. Investment property

<table>
<thead>
<tr>
<th></th>
<th>Scenario 1: Fair value model</th>
<th>Scenario 2: Cost model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Calculation:</strong></td>
<td><strong>R'000</strong></td>
<td><strong>R'000</strong></td>
</tr>
<tr>
<td>1 January</td>
<td><strong>20.2</strong></td>
<td>20.2</td>
</tr>
<tr>
<td>• Gross carrying amount</td>
<td><strong>25 000</strong></td>
<td><strong>20 000</strong></td>
</tr>
<tr>
<td>• Accumulated depreciation</td>
<td><strong>20 000</strong></td>
<td>(2 000)</td>
</tr>
<tr>
<td>Additions arising from business combinations</td>
<td><strong>At fair value</strong> 10 000</td>
<td><strong>Given</strong> 10 000</td>
</tr>
<tr>
<td>Capitalised subsequent expenditure</td>
<td><strong>Given</strong> 2 500</td>
<td><strong>Given</strong> 2 500</td>
</tr>
<tr>
<td>Fair value adjustment</td>
<td><strong>Balancing figure</strong> 500</td>
<td>-</td>
</tr>
<tr>
<td>Impairment</td>
<td><strong>-</strong></td>
<td>(9 000)</td>
</tr>
<tr>
<td>Depreciation</td>
<td><strong>-</strong></td>
<td>(1 588)</td>
</tr>
<tr>
<td><strong>31 December</strong></td>
<td><strong>Given</strong> 38 000</td>
<td><strong>19 912</strong></td>
</tr>
<tr>
<td>Analysed as follows:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Gross carrying amount</td>
<td>[R20 000 + R10 000 + R2 500]</td>
<td>32 500</td>
</tr>
<tr>
<td>• Accumulated depreciation and accumulated impairment</td>
<td>[R2 000 + R1 588]</td>
<td>(12 588)</td>
</tr>
<tr>
<td>The carrying amount includes unlet property with a carrying amount of</td>
<td><strong>Given</strong> 8 000</td>
<td><strong>Given</strong> 8 000</td>
</tr>
</tbody>
</table>

Suitably qualified professional valuers with recent experience in valuing similar property in the same locations were employed to determine the fair value of the group’s investment properties at 31 December 20.2.

The fair value of the Sandton investment property was determined at R30 million with reference to the sale of two similar buildings in Sandton as both sales took place during December 20.2. Both sales were transacted at Rx xxx per square metre and this was used to compute the fair value of the investment property.

The fair value of the Downtown Johannesburg property was determined at the present value of the expected future fair market rentals for the property taking into account the deterioration of the property market in Downtown Johannesburg.
### PICTORIAL LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20.2

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Scenario 1: Fair value model</th>
<th>Scenario 2: Cost model</th>
</tr>
</thead>
<tbody>
<tr>
<td>R’000</td>
<td>20.2</td>
<td>20.2</td>
</tr>
</tbody>
</table>

### Scenario 1:
**Fair value model**

**Scenario 2:**
**Cost model**

#### Note 3. Profit from operations
Profit from operations is stated after:

**INCOME:**
Income from investment properties:
- rentals $R100 Sister \times 12\text{ months}$ from note 13: 1 200
- fair value adjustment: 500

**EXPENSES:**
Operating costs of investment property:
- occupied by tenants $R500 \text{ repairs} + R400 \text{ rates}$: 900
- unoccupied $R50 \text{ repairs} + R200 \text{ rates}$: 250

Impairment of investment property: From note 13: 9 000

### 4. RECOGNITION OF A PROPERTY INTEREST UNDER A LEASE AS INVESTMENT PROPERTY

#### 4.1 Recognition of a property interest under an operating lease as investment property

An entity which holds (as lessee) a property interest under an operating lease may classify and account for this property interest as investment property if, and only if:
- the property would otherwise meet the definition of an investment property, and
- the lessee uses the fair value model for the asset recognised.

This classification alternative is available on a property-by-property basis. However, once selected, then all investment property must be accounted for using the fair value model. The initial cost of a property interest held under a lease and classified as an investment property is accounted for as a finance lease and is recognised at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount is recognised as a liability (paragraph 25).
4.2 Recognition of a property interest under a finance lease as investment property

Investment property may also be acquired under a finance lease (para. 3 and 8(c) of IAS 40).

Illustrative example 16.5: Initial recognition of property interest under a finance lease as an investment property

On 1 October 20.5, Inprop Limited entered into a finance lease (as lessee) over an office-block with a fair value of R7 000 000, when the estimated remaining economic life of the office-block subject to the lease was 20 years. The lease provides for 120 arrear monthly lease payments of R96 000 each, payable by Inprop Limited to the lessor on the last day of each month. On 2 October 20.5, Inprop Limited entered into several ten-year sublease agreements with various tenants such that the entire office-block is sublet under operating subleases. Total sublease income per the sublease agreements is R104 000 per month payable in arrear by the tenants to Inprop Limited on the last day of each month. The directors of Inprop Limited elected to account for its leasehold interest in this property as an investment property.

An appropriate discount rate at 1 October 20.5 was a flat rate of 12% per annum. This rate had declined to 10% by 31 December 20.5.

Required:
1. Compute the amount that will in accordance with IAS 40 will be capitalised to investment property;
2. Prepare the reconciliation of the carrying amount of Inprop Limited’s investment property from 1 January 20.5 to 31 December 20.5 for inclusion in the notes to Inprop Limited’s 31 December 20.5 annual financial statements.
3. Compute the carrying amount of Inprop Limited’s finance lease liability at 31 December 20.5.

Solution:

Requirement 1

Investment property

<table>
<thead>
<tr>
<th>Explanation/Calculation:</th>
<th>Rand</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>6 691 250</td>
</tr>
</tbody>
</table>

Requirement 2

Carrying amount at 1 January 20.5

<table>
<thead>
<tr>
<th>Additions</th>
<th>6 691 250</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount at 31 December 20.5</td>
<td>7 199 543</td>
</tr>
</tbody>
</table>

Requirement 3:

Carrying amount of lease liability at 31 December 20.5

| (W2) | 6 603 113 |
**Workings:**

(W1)

Cost of the investment property

<table>
<thead>
<tr>
<th>Calculation:</th>
<th>Rand</th>
</tr>
</thead>
<tbody>
<tr>
<td>$n = 120, PMT = 96,000, I = 1.00^* \text{, COMP PV}$</td>
<td>6 691 250</td>
</tr>
<tr>
<td>( (i.e.12%/12\text{months}) )</td>
<td></td>
</tr>
</tbody>
</table>

(W2)

Finance lease liability

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount (R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 October 20.5</td>
<td>6 691 250</td>
</tr>
<tr>
<td>Interest accrual</td>
<td>66 913</td>
</tr>
<tr>
<td>Payment</td>
<td>(96 000)</td>
</tr>
<tr>
<td>31 October 20.5</td>
<td>6 662 163</td>
</tr>
<tr>
<td>Interest accrual</td>
<td>66 622</td>
</tr>
<tr>
<td>Payment</td>
<td>(96 000)</td>
</tr>
<tr>
<td>30 November 20.5</td>
<td>6 632 785</td>
</tr>
<tr>
<td>Interest accrual</td>
<td>66 328</td>
</tr>
<tr>
<td>Payment</td>
<td>(96 000)</td>
</tr>
<tr>
<td>31 December 20.5</td>
<td>6 603 113</td>
</tr>
</tbody>
</table>

(W3)

Fair value of leasehold interest

<table>
<thead>
<tr>
<th>Calculation:</th>
<th>Amount (R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>( PMT = 8,000, n = 117, I = 0.8333^* \text{, COMP PV} )</td>
<td>596 430</td>
</tr>
<tr>
<td>.Computation of ( PMT ) = (R104 000 \text{inflow} – R96 000 \text{outflow}) = R8 000</td>
<td></td>
</tr>
<tr>
<td>Computation of ( n ) = (120 months – 3 passed) = 117 months</td>
<td></td>
</tr>
<tr>
<td>Computation of ( i ) = (10%/12\text{months} \times 100) = 0.833\text{33%}</td>
<td></td>
</tr>
<tr>
<td>Add: Finance lease liability</td>
<td>6 603 113</td>
</tr>
<tr>
<td>Reported carrying amount (fair value of investment property)</td>
<td>7 199 543</td>
</tr>
</tbody>
</table>

Fair value adjustment

<table>
<thead>
<tr>
<th>Amount (R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>( R6,691,250 \text{ initial recognition} – R7,199,543 \text{ subsequent (above)} )</td>
</tr>
</tbody>
</table>

---

### 5. ACCOUNTING FOR PROPERTY HELD FOR SALE IN THE ORDINARY COURSE OF BUSINESS

Property held for resale in the ordinary course of business is classified as inventory and accounted for in accordance with IAS 2 – *Inventories*.

### 6. CHANGE IN THE CLASSIFICATION OF FIXED PROPERTY

Paragraph 57 of IAS 40 - *Investment property* provides for transfers to and from investment property (as defined) when, and only when, there has been a change in use as evidenced by specified limited circumstances.

#### 6.1 Change in classification: The reporting entity uses the cost model

Paragraph 59 provides:

“When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement and disclosure purposes.”

#### 6.2 Change in classification: The reporting entity uses the fair value model

IAS 40 provides detailed guidance in respect of changes in the classification of investment property where the reporting entity uses the fair value model of accounting for investment property.
6.2.1 **Investment property (fair value model) becomes an owner-occupied property or inventory**

An investment property becomes:

- an owner-occupied property when the owner occupies the property, or
- inventory when development of the property with a view to sale commences. A decision to dispose of an investment property is therefore not on its own enough to warrant a change in classification. Only where the change of intention is coupled with development, can a transfer to inventory be accounted for.

The fair value of the investment property (accounted for on the fair value model) on the date of change in use becomes the cost of the owner-occupied property or inventory as the case may be (paragraph 60).

**Illustrative example 16.6: Investment property becomes occupied by a subsidiary**

On 1 January 20.2, Pasta Limited acquired 75% of the ordinary share capital of Salad Limited. Pasta Limited accounts for:

- investment properties on the fair value model, and
- property, plant and equipment at depreciated historic cost.

Buildings classified as property, plant and equipment are depreciated on the straight-line method to nil residual values over an expected useful life of 20 years.

Pasta Limited has one investment property (an office building) which it purchased at a cost of R20 million on 1 January 20.0. Pasta Limited immediately entered into an operating lease with Salad Limited over this building. The five-year lease was entered into on 1 January 20.0, and has the following terms:

- Lease rentals of R100 000 per month are payable monthly in arrear on the last day of each month;
- Pasta Limited is responsible for the maintenance of the building.

The fair value of the investment property at 31 December 20.2 is R25 million (20.1: R22 million).

During 20.2 Pasta Limited incurred R250 000 maintenance expenditure on the investment property.

Other than as is discernable from the information provided, Pasta Limited and Salad Limited have no investment property and no property, plant and equipment.

**Required:**

Prepare, in respect of investment property only, in columnar format for Pasta Limited and the Pasta Limited Group:

- Extracts from the statement of financial position (and notes thereto) at 31 December 20.2, and
- Extracts from the notes to the statement of comprehensive income for the year ended 31 December 20.2.

Neither comparative figures nor accounting policy notes are required.
Solution:

PASTA LIMITED
STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20.2

<table>
<thead>
<tr>
<th>Note</th>
<th>COMPANY</th>
<th>GROUP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Calculation: 20.2</td>
<td>Calculation: 20.2</td>
</tr>
<tr>
<td></td>
<td>R’000</td>
<td>R’000</td>
</tr>
</tbody>
</table>

ASSETS
Non-current assets
- Investment property 13 Given 25 000 |
- Property, plant and equipment (not required) 14 - R22 million x 17/18 yrs 20 778

PASTA LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20.2

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>GROUP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculation: 20.2</td>
<td>Calculation: 20.2</td>
</tr>
<tr>
<td>R’000</td>
<td>R’000</td>
</tr>
</tbody>
</table>

Note 3. Operating profit
Operating profit is stated after:

INCOME:
Income from investment properties
- rentals R100 x 12 1 200
- fair value adjustment R25 000 – R22 000 3 000

EXPENSES:
Depreciation – building - R22 000 + 18 yrs 1 222
Operating expenses in respect of rental generating investment properties Given 250

PASTA LIMITED
NOTES TO THE FINANCIAL STATEMENTS
AT 31 DECEMBER 20.2

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>GROUP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculation: 20.2</td>
<td>Calculation: 20.2</td>
</tr>
<tr>
<td>R’000</td>
<td>R’000</td>
</tr>
</tbody>
</table>

Note 13. Investment property
1 January
- Fair value adjustment Given 22 000
- Balancing figure 3 000
Transferred to property, plant and equipment upon becoming owner-occupied
- Given (22 000)
31 December
- Given 25 000

Suitably qualified professional valuer’s determined fair value with recent experience in valuing similar property in the same location.
Future lease receivables in respect of an operating lease:

<table>
<thead>
<tr>
<th></th>
<th>COMPANY</th>
<th>GROUP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculation:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>R'000</td>
<td>20.2</td>
<td>20.2</td>
</tr>
<tr>
<td>R100 x 12</td>
<td>1 200</td>
<td>Inter-group -</td>
</tr>
<tr>
<td>R100 x 24</td>
<td>2 400</td>
<td>Inter-group -</td>
</tr>
<tr>
<td></td>
<td>3 600</td>
<td>Inter-group -</td>
</tr>
</tbody>
</table>

- Receivable within 1 year
- Receivable between two to five years

6.2.2 **Owner-occupied property becomes an investment property (fair value model)**

An owner-occupied property becomes an investment property at the end of owner-occupation (i.e. when the owner vacates the property). Such a property would ‘always’ have been an investment property but for the fact that the owner-occupied it. Owner-occupied property is accounted for in accordance with IAS 16 and may therefore have been carried at its depreciated historic cost (benchmark) or at its depreciated revalued amount (allowed alternative). The ‘rules’ to account for the change to fair value accounting on the date of reclassification as an investment property, are identical to IAS 16’s ‘rules’ for accounting for a revaluation. Thereafter fair value accounting is applied. This change in classification to an investment property (on the fair value model) is accounted for as follows:

- **Decreases** in fair value to the date of change in classification are accounted for as impairments as follows:
  - decreases below depreciated historic cost are expensed in the determination of profit from operations,
  - decreases that reverse a prior revaluation are recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset.
- **Increases** in fair value to the date of change in classification are accounted for as follows:
  - increases up to depreciated historic cost (i.e. reversals of prior period impairments) are recognised in the determination of profit from operations for the period, and
  - other increases (i.e. the revaluation) are recognised in other comprehensive income and accumulated in equity (revaluation surplus reserve) and shall not in this nor any future period be recognised in the determination of profit from operations for the period.

6.2.3 **Inventory (property held for sale in the ordinary course of business) becomes an investment property (fair value model)**

Any difference between fair value of the property at the date of transfer and its previous carrying amount is recognised in profit or loss. Fair value accounting will apply thereafter.

7. **DISPOSALS**

An investment property shall be derecognised at the earlier of:

- the date of disposal, or
- when it is permanently withdrawn from use and no future economic benefits are expected from its disposal (i.e. retirement).

Gains and losses arising from disposal or retirement are recorded in profit or loss for the period. Where payment is deferred, the proceeds on disposal are initially recorded at the cash equivalent price.

Compensation from third parties for investment property that was impaired, lost or given up is recognised in profit or loss when the compensation becomes receivable (paragraph 72).
8. DEFERRED TAXATION

Where the fair value model is adopted, the carrying amount of the investment property changes with each valuation without a corresponding change in the tax base. Temporary differences therefore arise in respect of each valuation. In measuring the deferred tax arising from these temporary differences, in accordance with IAS 12 paragraph 51, the tax consequences that follow from the manner in which management intends recovering the carrying amount of the assets must be considered, and accounted for accordingly. Where management intend recovering the carrying amount of the investment property through immediate disposal the tax consequences are easily identified as the capital gain tax in respect of the appropriate portion of the capital profit determined in accordance with the Tax Act (effectively 50% x tax rate of the capital profit in excess of base cost for most South African companies), and the recoupment, if any, of past capital allowances granted by Revenue Services on that investment property {i.e. (50% x tax rate) for most South African companies}. Where recovery of the carrying amount is expected to be achieved through future lease rentals measurement of the deferred tax balance is less obvious, and has been the subject of much debate and in accordance with which numerous and often conflicting expert opinions have been issued. In the interests of consistency, this clearly is a matter in which the accounting standard setting authorities should issue an interpretation as a matter of urgency.

Illustrative example 16.7: Fair value model and deferred tax

Quickbuck Limited owns two investment properties:
- vacant land with a fair value of R5 million (original cost = R1 million); and
- administration building (the value of the land is ignored as it is immaterial) with a fair value of R50 million (original cost = R10 million).

The corporate income tax rate is 30% and the investment properties were acquired after capital gains tax came into effect in South Africa. SARS does not allow any capital allowances in respect of either of the investment properties. Management intend recovering the carrying amount of both investment properties through immediate disposal.

Required:
Compute the deferred tax liability, if any.

Solution (all figures in R’000):

<table>
<thead>
<tr>
<th></th>
<th>Carrying amount</th>
<th>Tax base</th>
<th>Temporary difference</th>
<th>Exemption</th>
<th>Subtotal</th>
<th>Deferred tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>5 000</td>
<td>-</td>
<td>5 000</td>
<td>1 000</td>
<td>4 000</td>
<td>600</td>
</tr>
<tr>
<td>Building</td>
<td>50 000</td>
<td>-</td>
<td>50 000</td>
<td>10 000</td>
<td>40 000</td>
<td>6 000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6 600</td>
</tr>
</tbody>
</table>

Calculation of deferred tax:
- 50% CGT x 30% x R4 000
- 50% x 30% x R40 000

Explanation: A recoupment is not taken into account as no tax allowances were given.

9. SUMMARY

This chapter has provided a comprehensive overview of IAS 40 – Investment Property. For guidance on measuring the fair value of an investment property, it is necessary to consult IFRS 13 – Fair Value Measurement.

Aligning the definition and recognition criteria to that of the Framework ensures that the principles in IAS 40 are based on sound concepts. Users of financial statements require relevant information and those entities which choose to use fair value will provide more relevant information to the users.