CONSIDERATIONS ON THE VALUATION AND ACCOUNTING OF INVESTMENT PROPERTY IN THE CURRENT ECONOMIC ENVIRONMENT

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***Abstract**: In recent years, an increasingly greater importance has been given to investment properties, which tend to become a reality of the assets of many companies. It is not hard to guess why the specialised bodies, namely the accounting normalization or valuation ones, have reserved distinctive sections of standards/regulations meant to provide recommendations for a credible valuation and an adequate recognition. This article approaches investment properties from multiple perspectives, emphasizing the manner of valuating the value of investment properties and of their correct accounting, thus creating the premises for the increase in the quality of the information used in the decisional acts of the information users.*

Keywords: investment properties, IFRS, IAS 40, fair value.

JEL Classification Codes: M41.

1. INTRODUCTION

The major objective of any business entity is to create added value for its investors. We can identify added value especially in terms of profit or equity increase in general, following operating or financial activities. For very many years, there has been a permanent concern of companies to invest their funding sources in fixed tangible assets able to generate future cash flows either directly, or as a result of supporting the production/sale or administrative activity.

National accounting rules and the recommendations of the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board have special sections dedicated to the manner of identifying and the accounting treatment of investment properties which is delimited from other real properties (which are used by the company to carry out the current activities for which it is authorised or for administrative purposes). Nevertheless, as in the case of other types of assets, companies can choose between certain types of accounting treatments which will be in compliance with the adopted accounting policy, aiming at gaining either a fiscal advantage, or at fulfilling a certain purpose of presenting information in the financial statements.

Beyond the accounting profession, the intersection with the professional valuator one brings to the forefront of the research aspects leading to the conclusion that the expertise of the latter is recommended for the valuation and for financial reporting purpose, to the detriment of a valuation carried out by an accounting specialist.

2. THE ACCOUNTING REFERENCE SYSTEMS APPLICABLE TO COMPANIES AND THE ACCOUNTING TREATMENT OF INVESTMENT PROPERTIES

In Romania, two different accounting reference systems are applicable, as follows: the companies the shares of which are not traded on a regulated stock exchange apply the accounting regulations approved by Order no. 1802/2014 approving the accounting regulations concerning the individual and the consolidated annual financial statements, while the companies the shares of which are traded on a regulated stock exchange apply the IFRS approved by Order no. 2844/2016 approving the accounting regulations compliant with the International Financial Reporting Standards. Although, following the general analysis of the two reference accounting systems, we can ascertain that there is a high degree of convergence (the standards observed by each country, including the national one, being, of course, the convergence with the IFRS) we can see, nevertheless, the existence of certain differences in terms of accounting treatment and presentation in the financial statements of items entered in the financial position. We will develop, hereunder, these aspects centred around investment properties, which represent the main objective of the research paper.

In Order no. 1802/2014 approving the accounting regulations concerning the individual and the consolidated annual financial statements, the real estate investment is defined as being "the property (land or a building – or part of a building – or both) held (by the landlord or the tenant based on a financial lease contract) rather than to obtain incomes from rent or to increase the value of the equity, or both, rather than for:

a) to be used for manufacturing or supplying goods or providing services or for administrative purposes; or

b) to be sold during the normal business course".

Thus, a clear delimitation is made from the real estate property used by the holder, more specifically, "the real estate held (by the landlord or by the tenant based on a financial lease contract) in order to be used for manufacturing or supplying goods or providing services or for administrative purposes".

IAS 40 "Investment property" (which approaches the problem of investment properties, as suggested by the standard name itself), presents the same manner of defining the two types of assets, except that instead of using the phrase "the property used by the tenant based on a financial lease contract" it uses "the property used by the tenant as a right-of-use asset".

Both accounting referential standards show examples concerning the inclusion of real estate in the category of tangible assets of the land/building type, or investment properties or stocks (and the conditions for their transfer from one category to another), also laying emphasis on other aspects, such as:

- if the property includes parts with a different utility (one part that is held with the purpose of being rented or with the purpose of increasing the equity value, and another part that is held with the purpose of being used to manufacture or to supply goods, or to provide services, or for administrative purposes), an analysis is carried out in order to see whether these parts can be sold or rented separately:
  - if the answer is yes, they will be accounted for separately;
  - otherwise, the real estate will be classified as real estate investment provided that only an insignificant part of it is held with the purpose of being used in to manufacture or to supply goods, or to provide services, or for administrative purposes.

- if the entity supplies auxiliary services to the tenants of a real estate it holds, an analysis is carried out in order to see whether the services in question represent an insignificant component if the entire contract or not:

- if the services in question are an insignificant component if the entire contract, then the entity will treat the real estate as a real estate investment;
- if the provided services are a significant component, the real estate represents a real estate used by the holder rather than a real estate investment.

- in a group of companies, a real estate that is rented and occupied by the mother company or by another affiliate is, from the point of view of the group, a real estate used by the holder, and from the point of view of the entity that holds it, the real estate is a real estate investment (an investment property), if it fulfils the conditions for the inclusion into this category.

We will analyse hereunder the aspects related to the valuation and recognition of property investments in the accounting, according to the two reference accounting systems presented above.

Table no. 1 The accounting valuation of investment properties according to Order no. 1802/2014 of the Minister of Public Finance

	Order no. 1802/2014 approving the accounting regulations concerning the individual and the consolidated annual financial statements	**Observations**
Initial valuation	At the entrance in the entity, property investments are valuated and recorded in the accounting records at the initial value, which is set as follows: a) at the purchase cost – for the goods bought against payment; b) at the production cost – for the goods manufactured in the entity; c) at the contribution value, determined following the valuation – for goods representing a contribution to the equity; d) at fair value – for goods obtained free of charged or found as a plus at the inventory. In the cases mentioned at letters c) and d), the contribution value and the fair value respectively replace the purchase cost.	The general recognition, valuation and depreciating rules applicable to tangible assets are applied.
Presentation in the financial statements	They are valuated at the book value, reconciled with the inventory results. The valuation of the tangible assets at the balance sheet date is made: -at **cost**, minus the amortization and accumulated impairment adjustments, ***or*** -at **revaluated value**, which is the **fair value** at the revaluation date.	

Table no. 2 The accounting valuation of investment properties according to IFRS (IAS 40)

	International Financial Reporting Standards (IFRS)	Observations
Initial valuation	An own property investment must be **initially** valuated at **cost**. Trading costs must be included in the initial valuation. The cost of a property investment bought contains the purchase price and any other direct expenses (fees, ownership transfer taxes, etc.). Current operating and maintenance costs of a property investment are recognized in the profit or loss of the period as they appear.	
Subsequent valuation and presentation in the financial statements	After the initial recognition, an entity must choose as accounting policy: - either ***the model based on the fair value***, -or ***the model based on cost*** and must apply this policy to all its property investments. After the initial recognition, an entity *that chooses* ***the model based on the fair value*** must evaluate all its property investments at fair value, except when it is not able to evaluate them at fair value reliably. After the initial recognition, an entity *that chooses* ***the model based on cost*** must evaluate all its property investments (IAS 40, item 56): (a) "according to IFRS 5 "Non current Assets Held for Sale and Discontinued Operations" when the criteria are met to be classified as held for sale (or are included in a disposal group that is classified as held for sale); (b) according to IFRS 16 "Leases" if they are held by the tenant as a right-to-use asset and are not held for sale according to IFRS 5; and (c) according to the provisions of IAS 16 "Property, Plant and Equipment" for the cost model in all the other cases."	A profit or a loss based on a change in the fair value of the property investment must be recognized in the profit or loss of the period where it appears.

Example no. 1 (model adapted from CECCAR, 2017 – with own data):

An entity that has its actions listed at the Bucharest Stock Exchange (BVB), which organizes and manages its accounting according to the IFRS, purchased on 31.12.N-a building at the cost of 120,000 mu, with the purpose of renting it to third parties based on an operating lease. The fee paid to a real estate agent was 1,500 mu, and the notary fees paid for the ownership transfer amounted to 2,340 mu. The useful life of the building was set at 12 years, and the depreciation used is the straight line depreciation. The entity uses the cost model to evaluate the building.

On 01.06.N, the building is rented to third parties. At this moment, the entity chooses for the evaluation of the property investment the fair value model, and property investment is evaluated at 122,000 mu.

On 31.12.N, the fair value becomes 140,000 mu.

On 31.12.N+1, the fair value becomes 135,000 mu.

The following are required:

The initial recognition of the property investment;

The recognition of the depreciation of the period before the selection of the fair value model;

The recognition of the investment property evaluated at its fair value as at 01.06.N;

The recognition of the investment property evaluated at its fair value as at 31.12.N;

The recognition of the investment property evaluated at its fair value as at 31.12.N+1.

a) The initial recognition of the investment property at its cost 123,840 mu (120,000 +1,500 + 2,340)

2152	=	**404**	**123,840** mu
Investment properties evaluated at cost		**Fixed asset suppliers**	

b) Recognition of the depreciation corresponding to the 01.01.N-01.06.N (January-May, 5 months) period:

Cost 123,840 lei
Annual depreciation = 123,840 mu / 12 years= 10.320 mu => Monthly depreciation =10,320 mu/ 12 months = 860 mu / month
Depreciation of the 01.01.N-01.06.N period = 860 mu / month x 5 months= 4,300 mu

6811	=	**2815**	**4,300** mu
Operating expenses related to the depreciation of the fixed assets, investment properties and productive biological assets evaluated at cost		**Depreciation of the investment properties evaluated at cost**	

c) The recognition of the investment property at its fair value, as at 01.06.N

Situation of the investment property as at 01.06.N:

Purchase cost	123,840 mu
Amortization of the 01.01.N-01.06.N period	4,300 mu
Remaining value at 01.06.N =123,840 mu – 4300 mu	119,540 mu
Fair value at 01.06.N	122,000 mu
Earning=122,000 mu –119 540 mu	2,460

- cancelation of the depreciation

2815	=	**2152**	**4,300** mu
Depreciation of the investment properties evaluated at cost		**Investment properties evaluated at cost**	

- inclusion of the investment property initially recognized at cost, into the category of those recognized at fair value

2151	=	**%**	**122,000** mu
Investment property evaluated at the fair value		**2152** **Investment property evaluated at cost**	**119,540** mu
		7561 **Earnings from the evaluation of the investment properties at fair value**	**2,460** mu

d) The recognition of the investment property at its fair value, as at 31.12.N

Situation of the investment property as at 31.12.N:
Fair value at 01.06.N 122,000 mu
Fair value at 31.12.N 140,000 mu
Earning from the change in the fair value = 140,000 mu – 122,000 mu = 18,000 mu

2151	**=**	**7561**	**18,000** mu
Investment property evaluated at the fair value		**Earnings from the evaluation of the investment properties at fair value**	

e) The recognition of the investment property at its fair value, as at 31.12.N+1

Situation of the investment property as at 31.12.N+1:
Fair value at 31.12.N 140,000 mu
Fair value at 31.12.N+1 135,00 mu
Loss from the change in the fair value = 135,000 mu -140,000 mu = 5,000 mu

6561	**=**	**2151**	**5,000** mu
Loss from the evaluation of the investment properties at fair value		**Investment property evaluated at the fair value**	

Following the example shown hereinabove, we can conclude as follows:

The situation of the presented company, which applies the IFRS
- At the initial valuation, investment properties are evaluated at the cost that includes any attributable direct costs;
- At the valuation following the initial recognition, the entity has chosen to apply the accounting policy of presenting the investment properties at their fair value to the detriment of the cost model.
- The property investments accounted for at fair value are not depreciated. If the cost model had been chosen, they wold have been depreciated. Moreover, the depreciation criteria stipulated by IAS 36 “Impairment of assets” are not applicable. Its requirements are already met due to the fact that the fair value is used, which reflects the most likely price reasonably obtained in the market.
- The change in the fair value is recognized in the profit or loss of the period in which it appears (as we can see, the fair value differences affect the income accounts - account **7561** or expense accounts - account **6561)**

If the company had applied Order no. 1802/2014 of the Minister of Public Finance
- The initial valuation would have been carried out in a similar manner (at the purchase cost)
- The depreciation would have been recorded throughout the entire financial year
- If the company had chosen to record fixed assets in the balance sheet at the fair value set following the revaluation, at the end of the financial period, differences would have been recorded between the fair value and the book value which could have affected:

- The line “Revaluation reserves” (a distinctive equity element, a distinctive sub-element in "Capital and reserves”);
- Or the current result, the line "Profit or loss" ("Incomes from the revaluation of fixed tangible assets" if, in the event of the addition of value, expenses should be compensated from a previous revaluation, ***or*** "Expenses from the revaluation of fixed tangible assets ", if, in the event of a negative value, there is no reserve from revaluation previously recorded for the fixed asset in question or if that reserve is insufficient.

3. WHO EVALUATES INVESTMENT PROPERTIES AND HOW IS THE VALUATION CARRIED OUT?

The assessment of the purchase or the manufacturing cost does not generally raise problems for the professional accountant. If no other goods identical to the investment property belonging to the company are sold on an active market, we believe that the assessment of the contribution value, of the present value (determined when the inventory was performed) or of the fair value, are values that need knowledge which in many cases exceed the level of professional training of the accountants, and thus a desirable solution is to resort to specialised valuators.

The accounting legislation recommends, but does not require, to resort to authorised valuators in order to assess the fair value. Thus, the accounting regulations applicable to non-listed companies mention that “The fair value of assets is generally assessed based on the accounting data in the market, through a valuation usually performed by authorised valuators, in compliance with the law. If there is no data concerning the fair value in the market, due to the specialised nature of the assets and the low frequency of their transactions, the fair value can be assessed by other methods usually used by authorised valuators” (Order no. 1802/2014 of the Minister of Public Finance, art. 75). The fair value of the fixed tangible assets is generally assessed starting from their market value, based on the information that would be used by the market participants when they set the asset price, assuming that the market participants act to obtain a maximum profit.

If the entity resorts to an authorised valuator for the assessment of the fair value of the investment properties, then an analysis of the standards they observe in order to assess the value of accounting purposes is required. In our opinion, the main reference standard is International Valuation Standard 300 “Valuations for Financial Reporting” (IVS 300). The standard provides that “valuations made with the purpose of being included in a financial statement will be done in such a way as to observe the requirements of the applicable Financial Reporting standards. The principles contained in the general standards (IVS 101 Scope of Works, 102 Implementation and 103 Reporting) are also applicable, except when they are especially amended by a requirement in the relevant accounting standard or in this standard “(Anevar, 2018).

In order to assess the fair value, IVS 300 refers to IFRS 13 “Fair value measurement” which includes the following definition “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.”

From the analysis of IFRS 13, we can conclude that the selection of a certain valuation technique takes into account the hypotheses the market participants would use in order to set the asset price, the best use of the asset (in order to obtain maximum profit) and the quality and quantity of the entry data for valuation, minimizing the use of unobservable entry data.

In order to improve the consistency and comparability of valuations at fair value and the presentations of connected information, the current IFRS 13 sets a hierarchy of the fair value which classifies entry data on three levels for the valuation techniques used to assess the fair value:

- ***1st level entry data***- these are listed (unadjusted) prices on active markets for identical assets and liabilities, to which the entity has access on the valuation day;

- ***2nd level entry data***- they are different entry data for the listed prices included in the 1st level, which are directly or indirectly observable for the asset or the liability;

- ***3rd level entry data*** – they are entry data unobservable for the asset or the liability.

In the fair value hierarchy, a priority level is held by the listed (unadjusted) prices on active markets for identical assets (1st level entry data), and the lowest priority is held by the unobservable entry data (3rd level entry data).

In order to assess the fair value, an entity must use valuation techniques that are consistent with one or more of the following three general approaches recognized in valuation: the market approach, the cost approach, and the income approach.

According to the specialised literature, the capacity of a property to generate income has an obvious relevance in the property valuation. Such properties are developed and purchased as investment opportunities, and the common objective of the contractors and buyers is to make profit from their investments. The profit grows proportionally with the capacity of the real property to generate profit and, consequently, the value of its investment is bigger. This represents the essence of the income approach and of all related theories and techniques (Charles B. Akerson, 2014).

Example no. 2

We will describe hereafter ***a simplified example of valuation of a real estate*** (in the hypothesis that it is held by a real estate investment company), using a valuation method included in the income approach category. We are assuming that the property is a storage building with a rentable area of 5,500 square meters, for which the contractual rent, equal to the market one, is 4 mu /m^2/month. The 8% vacancy rate, the expense rate for similar properties is 35% to which 0.20 mu /m^2 inhabitancy allowances are added. The request is to assess the net operating income and the property value by direct capitalization knowing that the average price for similar properties is 270 mu /m^2.

Solution:

- **the net operating income will be calculated**

Gross operating income (VBE) = 5,500 m^2×4 mu /m^2/month ×12 months ×0.92

= 242,880 mu

Net operating income (VNE) = 242,880 mu – (242,880 mu ×0.35+0.20 mu /m^2×5,500 m^2)
= 156,772 mu

- **the value of the property (investment property) is determined by direct capitalization:**

Price =270 mu/m^2 ×5,500 m^2 = 1,485,000 mu

Gross operating income (VBE) : 5,500 m^2×4 mu/m^2/month ×12 months ×0.92 = 242,880 mu

Multiplier $_{VBE}$= Preț/VBE=1.485.000 mu: 242,880 mu = 6,11

The overall capitalization rate (R_0) = (1- expense rate for similar properties %) / Multiplier $_{VBE}$

= (1- 0.35) /6.11 = 0.65/6.11 = 0.1063 = 10.63 %

The property value (investment property) = VBE/ R_0 **=** 242,880 mu: 10.63 % = 2,284,854 mu

4. CONCLUSIONS

Analysing the provisions of the two reference accounting systems, we can see that the initial valuation and accounting of the investment properties are not different. After the initial valuation, non-listed companies can present property investments in their balance sheet at **cost**, minus the depreciation and cumulated depreciation adjustments, ***or*** at **the revaluated value**, which is the **fair value** at revaluation date. Listed companies, which apply the IFRS, after the initial recognition, choose as accounting policy either **the fair value model,** or **the cost model.**

According to the IFRS, investment properties recorded at their fair value are not depreciated (if the cost model is chosen, they will be depreciated). Moreover, the depreciation criteria stipulated by IAS 36 "Impairment of assets" are not applicable. Its requirements are already met due to the fact that the fair value is used, which reflects the most likely price reasonably obtained in the market. The change in the fair value is recognized in the profit or loss of the period in which it appears (as we can see, the fair value differences affect the income accounts - account 7561 or expense accounts - account 6561)**.** *From the fiscal point of view,* incomes representing the chance in the fair value of investment properties as a result of the subsequent valuation using the fair value model are deemed *non-taxable incomes*. These amounts are taxed together with the deduction of the fiscal amortization, or when these investment properties are removed from the inventory, respectively, as the case may be. Also, the expenses representing the change in the fair value of the property investments are deemed *non-deductible expenses*, if, as a result of the subsequent valuation using the fair value model by taxpayers who apply accounting regulations in compliance with the International Financial, Reporting Standards, a decrease in their value is recorded.

According to Order no. 1802/2014 of the Minister of Public Finance, if then entity chose to record fixed assets in the balance sheet at fair value determined as a result of the revaluation, at the end of each financial period, differences will be recorded between the fair value and the book value that might affect the line "Revaluation reserves" (a distinctive equity element, a distinctive sub-element in "Capital and reserves") or the present result, the line "Profit or loss". *From the fiscal point of view,* incomes representing increases in the value resulting from the revaluation of the fixed assets that compensate the expenses with the previous decreases corresponding to the same fixed assets are deemed *non-taxable incomes*. Also, expenses from the revaluation of fixed tangible assets are deemed *non-taxable incomes*, a decrease in their value is ascertained.

In the content of this article, we expressed our opinion according to which the assessment of the purchase or manufacturing cost does not generally raise problems for the professional accountant. If no other goods identical to the investment property belonging to the company are sold on an active market, we believe that the assessment of the contribution value, of the present value (determined when the inventory was performed) or of the fair value, are values that need knowledge which in many cases exceed the level of professional training of the accountants, and thus a desirable solution is to resort to specialised valuators. If the entity resorts to an authorised valuator for the assessment of the fair value of the investment properties, in our opinion, the main reference standard is International Valuation Standard 300 "Valuations for Financial Reporting" (IVS 300). The standard provides that "valuations made with the purpose of being included in a financial statement will be done in such a way as to observe the requirements of the applicable Financial Reporting standards." The fair value, according to the IFRS, is consistent, in general, with the concept of market value, as defined and commented in the valuation standard IVS 100 Scope of Works. We consider that there are cases when the information in fair value are more relevant than that constituted on other valuation bases (Guşe R.G, 2011).

For example, if the fair value was assessed in relation to the real market prices, investors and other categories of creditors can assess the gross amount that could be obtained from the sale of assets, can assess the opportunity cost of holding the assets, especially in the case of investment properties that can be separated from the other assets and sold separately. If the cost model is adopted, for the presentation in the balance sheet, the principle of prudence does not allow for taking into account a potential value added to the present value (the asset value) in addition to the book value. Other arguments support fair value according to which it is considered that the fair value is the only type of relevant information for the financial decision, and the retreatment of the information expressed in historical costs require substantial effort from decision factors. The assessments used sometimes, specific to certain valuation methods, can be subjective due to their nature. For example, if the value of a real estate is assessed using the method of cash flows generated by operating the asset, it is necessary to assess the lifetime of the asset, its residual value, the cash flows it will generate over time, i.e. the discount rate (Brînzilă L., 2013), which in our opinion imply a professional judgement, sometimes characterized by strong subjectivity.

The change in the fair value leads to incomes/expenses reflected in the result (in the case of the application of Order no. 1802/2014 of the Minister of Public Finance, sometimes only the revaluation reserves can be affected). Given that part of the result is distributable to the company owners as dividends, we believe that the fair value differences should be taken into account only as adjustments of the asset value, for the determination of the net asset (the net property of the owners) but not in the distributable result, due to the fact that they are differences generated by the market, not incomes/expenses that imply actual cash flows.

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