

## **International Accounting Standards: A paradigm shift for corporate real estate?**

**Timothy Eccles\* and Andrew Holt**

*Received (in revised form): 1st October, 2001*

\*School of Surveying, Kingston University, Knights Park, Kingston upon Thames, Surrey KT1 2QJ, UK; Tel: +44 (0)20 8547 2000; Fax: +44 (0)20 8547 7087; e-mail: t.eccles@Kingston.ac.uk

**Timothy Eccles** is a senior lecturer in the School of Surveying at Kingston University, UK. He co-wrote with Andrew Holt the earlier papers in this journal 'Accounting for Property in the UK: The Legal and Professional Framework' and 'Accounting for Leasehold Property in the UK: A Triumph of Substance over Form?'.<sup>1</sup> He is also a co-author of the forthcoming 'Property and Construction Accounting' and of the in-print 'Property and Construction Economics'.<sup>2</sup> He is editor of the journal *Environments by Design*.

**Andrew Holt** is a senior lecturer in the School of Accounting and Finance at Kingston University, UK. He co-wrote with Timothy Eccles the earlier papers in this journal 'Accounting for Property in the UK: The Legal and Professional Framework' and 'Accounting for Leasehold Property in the UK: A Triumph of Substance over Form?'. He is co-author of the forthcoming 'Property and Construction Accounting'.

### **ABSTRACT**

*This paper is concerned with International Accounting Standards (IAS) and their impact upon existing accounting practices for property within the UK. It also anticipates the wider international and European demands for IAS. There are two primary points to consider. First, the European Union (EU) has stated that it expects publicly listed companies quoted on the stock exchanges of EU member states to adopt International Accounting Standards by 2005.*

*Others are encouraged to do so, with an implication that this will become mandatory at some future date. In earlier papers,<sup>3</sup> the authors examined the recent changes within property accounting and the role played by property professionals within that process. This paper examines the requirements of international standards within the context of the British position as explained earlier. Differences are noted, the contrasting debates analysed and suggestions offered for corporate real estate professionals to consider. Secondly, unlike British Accounting Standards, IAS do not recognise property professionals or any professional organisation representing them, such as the International Valuation Standards Committee (IVSC), and none of their regulations are represented within the standards. This situation is examined, and commentary provided upon the repercussions and possible solutions.*

**Keywords:** *accounting, international accounting standards, property, value*

### **INTRODUCTION**

The authors have offered previous examination<sup>4</sup> of the requirements of British accounting regulations and the extent to which they recognise, disregard and generally interact with valuation standards and the needs of corporate real estate. International Accounting Standards

(IAS) are rather different, however, in that they do not recognise traditional valuation concepts or the role of the valuation profession, even in the form of the International Valuation Standards Committee (IVSC). IAS can be seen purely as the work of accountants and those who operate within that professional field.<sup>5</sup> The rationale behind this concerns the purpose of IAS, which are developed from a need to create a framework to enable global investment on terms of parity. Free movement of capital, the work of international banks and the World Bank, and international trade are enabled by common development of terms and uniform principles of financial reporting for the stewardship of investments. International standards are imperative to this and lead those who wish to engender such frameworks. Stewardship is thus a primary motivation behind IAS. Of particular interest to European audiences is the acknowledgement of this fact by the EU and its decision to adopt IAS by 2005 for publicly quoted companies.

### **THE EMERGENCE OF INTERNATIONAL ACCOUNTING STANDARDS**

International Accounting Standards (IAS) have emerged from a relatively long and very political gestation process. Originally designed as a way for countries with ill-developed systems of national GAAP to adopt an internationally verified system of accounting, IAS have become much more. IAS rules are no longer derived exclusively from the Anglo-Saxon accounting rules of the US and UK, but have become distinct entities with their own conceptual framework.

The International Accounting Standards Board (IASB) is the body that oversees and controls the IAS project. It was originally formed as the International

Accounting Standards Committee (IASC) in 1973 through an agreement by professional accountancy bodies from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland and the United States of America. Between 1983 and 2001 IASC's members included all the professional accountancy bodies that were members of the powerful International Federation of Accountants. On 1st April 2001, a new body called The International Accounting Standards Board (IASB) was formed to undertake the standard-setting responsibilities of the IASC. At the time of this change, the IASB approved a resolution to adopt the existing IAS and interpretations already issued by the IASC. Any future international standards issued by the IASB will be called International Financial Reporting Standards (IFRS). The IASB, like its predecessor, is an independent body whose goal is to provide internationally recognised and approved accounting guidance and standards.

In terms of the UK accounting standard-setting arena, the newly formed IASB has a liaison member resident in the UK and the Board itself has offices in London. The IASB constitution envisages a 'partnership' between IASB and national standard setters as they work together to achieve the convergence and comparability of accounting standards in the global marketplace. The links between the UK's Accounting Standards Board (ASB) and the IASB are especially strong, as the former chairman of the ASB, Sir David Tweedie, is the current head of the IASB.<sup>6</sup>

For a considerable time now, the IASC/IASB and its standards have coexisted alongside national standard setters and national standards. However, this system of coexistence is about to change within Europe, following recent moves by

the EU to use the IASB's standards as the means to converge EU accounting practice. It is to this fundamental change that the paper will now turn.

### EUROPEAN UNION AND INTERNATIONAL ACCOUNTING STANDARDS

The reason behind the adoption of IAS by the EU is undoubtedly linked to the introduction of the Euro and moves towards a single European economy within the broadly recognised concept of the globalisation of capital markets and stock exchanges. At the same time, there are concerns within certain member states that have led to a determination to standardise reporting standards. For example, both Germany and Italy face problems related to shifting demographic structures and thereby implications upon traditional pension funding arrangements. Simply, increased personal provision via individual investment is necessary for the future, and this needs to be encouraged and protected by creating stewardship documents for such investments that are standardised and utilise universally accepted principles. The currently *ad hoc* nature of reporting requirements within individual member states includes national Generally Accepted Accounting Practice (GAAP), US GAAP and IAS.<sup>7</sup> This is not adequate for the perceived shift towards supra-national investment within the EU. Thus, the EU regards IAS as the preferable means of achieving comparability and competition, improved trust and investor protection and of allowing access to the EU from elsewhere and to elsewhere by EU-based companies. This has been a long process<sup>8</sup> by the EU in order to obtain agreement within its member states, and as will be seen causes some concerns within UK practice, as it revisits topics already debated thoroughly

and where consensus has been achieved. Of course, the decision to standardise accounting procedures has created a degree of nationalistic protection of individual approaches, which is why IAS were adopted as the basis for development. Being international, they were seen as less biased and avoided any danger of a move towards Americanisation via the use of US GAAP. Adoption also provides the EU with a powerful voice in the creation of IAS and the legislative ability to implement and enforce the regulations.<sup>9</sup>

### European Union enforcement

It is proposed that IAS will be a requirement for consolidated accounts of all EU listed companies. It will be optional (at this stage) for the consolidated accounts of unlisted companies and individual accounts. Translation into the 11 official EU languages is also problematic at this time, because of either poor translation of some of the terminology in existing foreign-language IAS documents or the impossibility of precisely defining certain terms within alternative socio-political legal frameworks.

The endorsement infrastructure will revolve around two main bodies:

- EU Accounting Regulatory Committee (with co-decision power of the Parliament)<sup>10</sup>
- European Financial Reporting Advisory Group (EFRAG), a private body involved in debate with the International Accounting Standards Board.<sup>11</sup>

### Accounting harmonisation revisited?

This movement to converge EU accounting practice using IAS as the conceptual framework is not the first attempt to harmonise European accounting. Immediately before the issuance of the EU Fourth Directive in 1980, an unsuccessful

attempt was made to harmonise EU accounting practice. At that time, the 'quick fix' solution as to what type of accounting showed a true and fair view was to agree a system of 'mutual recognition' between accounts prepared under each member state's generally accepted accounting principles (GAAP). Under this system, adherence to showing a 'true and fair' view in the accounts could be achieved not only by ensuring that the primary accounting statements were themselves true and fair (the 'Anglo-Saxon' approach) but that truth and fairness could be achieved by way of footnotes which revealed to what extent the primary statements were not true and fair (the 'Germanic' solution). It is beyond the scope of this paper to revisit the whole range of political and economic issues involved in the 'mutual recognition' solution, but it can at least partially explain the use of IAS as the starting point for the current EU 2005 programme of accounting convergence. By utilising an established and non-European accounting standards framework, namely that of the IASB, the EU Commission avoids being accused of promoting the accounting framework of one member state over that of another.<sup>13</sup>

## THE UK AND INTERNATIONAL ACCOUNTING STANDARDS

### Present use of International Standards by UK companies

There is currently very little evidence of IAS use by UK firms. A survey by Cairns (2000)<sup>13</sup> concluded that their use is virtually non-existent for UK listed firms. Even if one goes beyond the UK and considers *all* European listed companies, only 275 prepare their consolidated financial statements under IAS, 300 under US GAAP, and the remainder

(about 6,500 companies) use their national GAAP.<sup>14</sup> Even the 275 European companies that are actually using IAS do not always comply with the full requirements of IAS, choosing instead to apply a limited form of IAS 'lite' that should not technically be acceptable to company auditors.<sup>15</sup> Such evidence suggests that the limited use of IAS by listed companies is certainly not just an UK phenomenon.

The UK situation is not all that surprising, as there is currently little compulsion for UK companies to go to the expense of providing a dual set of accounts according to both UK GAAP and IAS GAAP. In fact, the only UK companies preparing 'dual' accounts are those that are also listed on the US stock market, in order to comply with the US Securities and Exchange Commission's (SEC) listing requirements. In these cases, US and UK GAAP are used and not IAS GAAP. Thus it seems that increased use of IAS by UK companies will only be brought about through the EU convergence effort. In order to examine this more fully, the following subsection describes in detail the present standing of IAS in terms of the current UK accounting, regulatory and reporting environment.

### UK accounting standards, International Standards and the law

The Companies Act 1985 currently requires all UK companies to produce accounts that show a 'true and fair' view. As Eccles and Holt (2001)<sup>16</sup> explain, the legal interpretation of this is that accounts must comply with UK<sup>17</sup> generally accepted accounting principles (GAAP) and standards in order to show a 'true and fair' view. However, when it comes to international accounting standards, there is currently no legal compulsion for UK companies to produce accounts that comply with them. Thus, it is entirely at the

discretion of an UK company if it wishes to prepare annual accounts or an accounting reconciliation compliant with relevant IAS.

Despite this lack of UK legal compulsion to use IAS, since the creation of the ASB every newly issued UK financial reporting standard (FRS) has included an appendix that outlines its level of compliance with the alternative rules provided by relevant IAS. Such appendices aim to outline differences in accounting approaches, so that accounting reports prepared under either basis can be reconciled and understood by UK accountants.

In earlier papers in this series<sup>18</sup> the authors outlined in detail the ASB approach to issuing UK accounting rules and standards. The IASB framework is very similar, with the main guidance on an accounting issue being contained in the relevant IAS. However, in addition to IAS, the Standing Interpretations Committee (SIC) of the IASB occasionally issues additional interpretations on certain issues called SICs. The interpretations issued by the SIC are approved by the IASB and form part of its authoritative literature. Therefore, financial statements should not be described as complying with IAS unless they comply with each applicable standard and each applicable interpretation issued by the SIC.

### **UK and International Accounting Standards relevant to property**

Table 1 provides a comparative summary of which IAS and UK standards contain the relevant accounting rules and guidance for the major types of property accounting issues. As the table clearly shows, the IASB and ASB have taken slightly different routes in developing their own accounting frameworks and rules systems to deal with property issues.

### **Appreciating the differences between IAS and UK GAAP**

For the property manager working for a UK listed company, it is vitally important to recognise the potential impact on reported performance of having to comply with IAS by 2005. Obviously, the switch from pure UK GAAP to IAS will not affect all companies equally. As Eccles and Holt<sup>19</sup> point out, companies with different exposures to wholly owned properties, leasehold properties, investment properties and construction contracts may well have their reported performance affected to differing degrees. While it should be pointed out that such accounting changes do not affect the underlying cash flow that a firm is producing, they can mislead the uninformed into believing that the firm's performance has either improved or declined. It is perhaps too early to ascertain the true impact of the move from UK GAAP to IAS, especially as the EU 'ratified version' of IAS has yet to be finalised. Despite this, however, the following section will aim to outline some of the main areas of difference between IAS and UK GAAP that a property manager should at least consider and appreciate.

### **COMPARISON OF IAS AND UK GAAP TREATMENT OF PROPERTY ISSUES**

The main areas of interest when comparing UK and IAS GAAP treatments of property issues are as follows.

#### **Accounting issue: Benchmark treatments and allowable options**

Before the paper compares UK GAAP and IAS GAAP in any detail it is important to recognise one important difference between ASB standards and IASB standards in the way they describe alternative treatment options available in certain standards.



**Table 1: IAS and UK GAAP relevant to property issues**

<i>Accounting issue</i>	<i>Existing UK guidance</i>	<i>Current IAS guidance</i>
Wholly Owned Property and other Tangible Fixed Assets	FRS 15 Tangible Fixed Assets	IAS 16 Accounting for Property, Plant and Equipment IAS 23 Borrowing Costs SIC 2 Consistency — Capitalisation of Borrowing Costs SIC 14 Property, Plant and Equipment — Compensation for Impairment or Loss of Items SIC 23 Property, Plant and Equipment — Major Inspection Costs
Impairment of Assets	FRS 11 Impairment of Assets and Goodwill	IAS 36 Impairment of Assets
Investment Property	SSAP 19 Investment Properties	IAS 40 Investment Properties
Leasehold Property	SSAP 21 Leases and Hire Purchase Contracts FRS 5 Reporting the Substance of Transactions	IAS 17 Accounting for Leases SIC 15 Operating Leases — Incentives SIC D27 Transactions in the Legal Form of a Lease
Revenue Recognition	ASB Discussion Paper 'Revenue Recognition' published 5 July 2001 SSAP 2 & the new FRS 18 Accounting Policies	IAS 18 Revenue
Stocks and Long-Term Construction Contracts	SSAP 9 Stocks and Work in Progress	IAS 2 Inventories IAS 11 Construction Contracts SIC 1 Consistency — Different Cost Formulas for Inventories

In some cases where an IASB Standard permits two accounting treatments for like transactions and events, one treatment is designated as the 'benchmark' treatment and the other as the 'allowed alternative' treatment. The IASC's 1990 Statement of Intent on the Comparability of Financial Statements<sup>20</sup> gave the following explanation:

'The Board has concluded that it

should use the term "benchmark" instead of the term "preferred" in those few cases where it continues to allow a choice of accounting treatment for like transactions and events. The term "benchmark" more closely reflects the Board's intention of identifying a point of reference when making its choice between alternatives.'

Seen in this light, the term 'benchmark'

is not meant to mean 'preferred' by the IASB, although it could be claimed to represent this. The benchmark treatment is thought to represent the treatment adopted by the majority of international companies and, through its use, to guarantee enhanced comparability between the accounts of international companies. In April 2001, the IASB announced its intention to commence a project to 'improve' the existing IASC Standards. It is likely that this programme of improvements will include an elimination of many, if not all, alternatives offered in the current standards.

In contrast to the IASB use of 'benchmark' treatments, ASB standards do not use such a deterministic terminology. Where an ASB standard allows alternative options, it is left to the discretion of the individual to determine the appropriate treatment that guarantees a true and fair view of the transaction.<sup>21</sup>

#### **Accounting issue: Valuation of tangible fixed assets**

The requirements of FRS 15 in the valuation of tangible fixed assets lead to compliance with IAS 16 and IAS 23 in most respects. This is not surprising, given the close work between the ASB and the IASC during the development of FRS 15. Also, as was indicated earlier in this paper, more recent ASB standards include an appendix explaining compliance with the relevant IASB standard. However, there are a number of differences between FRS 15 and IAS 16.

Under IAS 16, subsequent to initial recognition as an asset, the benchmark treatment for an item of property, plant or equipment is to carry it at its historic cost less any accumulated depreciation and any impairment losses. The allowable alternative treatment is to show the asset at its 'fair value'. FRS 15 also allows the option of keeping assets either at historic cost less

depreciation or at valuation. However, in contrast to IAS 16, FRS 15 does not offer a benchmark treatment, preferring to leave the decision to the individual accountant.

The main difference between FRS 15 and IAS 16 arises on how to revalue assets and is concerned with the terminology and methodology used in each standard. The valuation guidance contained in FRS 15 and IAS 16 are very different. As the authors' earlier paper showed, FRS 15 uses the 'value to the business' model and requires valuation at existing use, replacement cost or open market value, depending on the property.<sup>22</sup> In order to explain these concepts the FRS makes direct reference to Royal Institution of Chartered Surveyors' (RICS) definitions. Before IAS 16 was revised in 1998, it also referred to valuation at existing use and would have been consistent with FRS 15 and RICS definitions. However, the post-1998 version of IAS 16 no longer refers to existing use, but requires tangible fixed assets to be valued only at 'fair value', which is defined as:

'the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.'<sup>23</sup>

IAS 16 states that the fair value of land and buildings, plant and equipment is usually their market value, but where there is no evidence of market value depreciated replacement cost should be used instead. This is perhaps the biggest problem with IAS 16. It does not give the same clear and precise guidance on valuation as does FRS 15. FRS 15 was introduced in an effort to enhance the conformity and comparability of asset valuation practice in the UK. As it presently stands, IAS 16 seems to be a step backwards in this regard.

As examples of this, IAS 16 is completely silent in respect of whether valuations should be on an existing use basis and whether material direct acquisition or selling costs should be added or deducted. Furthermore, when it comes to the issue of how frequently assets need to be revalued, all IAS 16 states in paragraph 32 is that it:

‘depends upon the movements in the fair value of the items of property, plant and equipment being revalued.’

Thus the decision as to the frequency of revaluations is effectively left to the discretion of the individual accountant applying IAS 16. This stands in direct contrast to FRS 15, which gives clear and precise guidance on the frequency of asset revaluations. Finally, IAS 16 makes no direct reference to International Valuation Standard (IVS) concepts or methodology, except to say that ‘fair value’ is determined by appraisal *normally* undertaken by professionally qualified valuers. Once again, this stands in direct contrast to use of RICS definitions by FRS 15 and to the way the FRS clearly describes who should conduct asset valuations and requires details of precisely who has valued them.

#### **Accounting issue: Other issues concerning tangible fixed assets**

Apart from the problems over valuation guidance, the remaining differences between FRS 15 and IAS 16 and 23 are relatively minor. The main difference concerns the treatment of revaluation gains and losses. In order to comply with FRS 11 Impairment of Fixed Assets and Goodwill, FRS 15 requires revaluation losses that are clearly caused by the consumption of economic benefits to be recognised in the profit and loss account. IAS 16 does not have such a similar

requirement. Furthermore, IAS 16 permits only those losses that reverse revaluation gains that were previously recognised in the statement of total recognised gains and losses (STRGL) to be recognised in that statement. In contrast, FRS 15 goes further to require other losses to be recognised in the STRGL to the extent that the asset’s recoverable amount is greater than its revalued amount. This treatment best fits the idea that such losses, which have been demonstrated not to be impairments, are in the nature of losses caused by a general fall in prices.

Another minor issue is concerning the depreciation of tangible fixed assets. Both IAS 16 and FRS 15 state that subsequent expenditure on an asset does not negate the need for depreciation. However, FRS 15 also requires impairment reviews at the end of each reporting period where depreciation is not charged, while IAS 16 does not.

The final difference between IAS 16 and FRS 15 concerns the required disclosure requirements. IAS 16 requires additional disclosures about property, plant and equipment pledged as security for liabilities; the amount of expenditure on account of assets under construction; the amount of commitments for the acquisition of tangible fixed assets; and the revaluation surplus for each class of asset. However, even though FRS 15 does not also require such disclosures, they are a requirement of the Companies Act 1985.<sup>24</sup> Despite this, there are two disclosures that IAS 16 requires that are *not* required of a UK listed company, either by FRS 15 or the Companies Act 1985. These are a requirement to disclose for each class of property, plant or equipment the measurement bases used for determining the gross carrying amount, and the nature of any indices used to determine replacement cost.

In summary, then, it appears that there



needs to be some revision to IAS 16 in order to resolve the differences in the approach to the determination of the fair values of property, plant and equipment. This is clearly an important area where corporate property advisers need to ensure that future IASB developments are informed of the particular elements already agreed to by the UK national standard setters, the ASB, and which relied upon RICS definitions.

#### **Accounting issue: The capitalisation of borrowing costs**

The treatment of borrowing costs in FRS 15 is consistent with IAS 23. However, in IAS 23 it is interesting that the benchmark treatment is to expense borrowing costs in the profit and loss account when they occur. Although an allowed alternative treatment grants the option to capitalise in a very similar manner to that allowed by FRS 15, this is very informative as to the IASB's thoughts on the matter. In contrast, FRS 15 gives no guidance on the appropriate treatment except that the chosen treatment must be applied consistently across a class of assets and must show a true and fair view.

#### **Accounting issue: Impairment of assets**

The basic approach in IAS 36 Impairment of Assets is similar to that of FRS 11 Impairment of Fixed Assets and Goodwill. Impairment is measured by comparing the carrying value of fixed assets and goodwill with the higher of net selling price (equivalent to net realisable value) and value in use. Value in use is calculated by discounting the cash flows expected to be generated from the assets.

The detailed requirements of IAS 36 are also very similar to those in FRS 11. They differ in a number of areas, although most are not directly relevant to property assets and will be ignored here.

First, the FRS requires impairments of revalued assets that are clearly caused by the consumption of economic benefits to be recognised in the profit and loss account. In contrast, IAS 16 requires such impairments to be recognised in the profit and loss account only to the extent that the loss exceeds the balance on the revaluation reserve relating to the assets in question. Secondly, FRS 11 requires the accuracy of previous estimates of value in use to be monitored for five years following an impairment review. Any impairment that should have been recognised at the time must be recognised in the current period unless it has since reversed, in which case its non-recognition in past years should be disclosed. IAS 36 does not include such requirements. Finally, IAS 36 requires amounts recognised as impairment losses and reversals of impairment losses to be disclosed in more detail than does FRS 11.

#### **Accounting issue: Leasehold investment properties**

This issue is potentially the most politically sensitive of all accounting issues, when one compares IAS 40 Investment Property with SSAP 19 Accounting for Investment Property. Under the terms of IAS 40, a lessee cannot treat its interest in property held under an operating lease as investment property, even if the lessee acquired its interest in exchange for a large up-front payment or the lease has a very long term. Instead, the cost of such properties will have to be amortised in accordance with IAS 17 Leases. This exclusion of leasehold property from the definition of investment property under IAS 40 stands in direct contrast to SSAP 19. Under SSAP 19, leasehold property qualifies as investment property, and should be valued at open market value. However, SSAP 19 does state that such properties should be

depreciated over the period when the unexpired term is 20 years or less.

If IAS 40 is not changed, UK companies holding substantial portfolios of long-leasehold investment properties would face substantial economic consequences in their accounting records. It seems that the IASB will not change its stance until it reviews its standard on lease accounting. At the moment, the IASB wants to appear consistent in its treatment of operating leases, to the detriment of its treatment of leasehold investment property.

The treatment of leasehold property under IAS 40 is inconsistent with the treatment of leasehold property under IAS 16. It is absurd that a leasehold interest can be treated as property under one IAS but not another — and equally absurd that the interest can be revalued under one IAS and not another. It seems that the IASB must act on this, or at least that the EU must adopt a different version of both standards. Clearly, this is an area in which corporate real estate managers need to ensure their opinions are heard.

#### **Accounting issue: Gain or loss on revaluation of investment properties**

Another very important negative economic consequence of adopting IAS 40 Investment Properties concerns the treatment of gains or losses on the change in market value or fair value in each standard. As the authors discussed elsewhere,<sup>25</sup> SSAP 19 allows the gain or loss on revaluation to be taken to the STRGL rather than the profit and loss for the period, unless the loss is expected to be permanent. However, IAS 40 requires the gain or loss to be taken to the profit and loss account rather than to equity reserves. For example, if a company experiences a considerable amount of short-term losses in the market value of its investment property, due for example to

a short-term market downturn, it would seriously depress its reported earnings in its profit and loss account. Alternatively, in periods when investment property values are increasing, any gain will be reported in the main profit and loss account, even though the gain itself is an *unrealised* gain, which may or may not ever be realised.<sup>26</sup>

This debate about whether such gains or losses should be taken to yearly income or taken to equity reserves is an immensely political area both at UK and international levels. The ASB is currently at the exposure draft level in its plans to revise the main income statement and STGRL. It would not be a surprise if the IASB takes action in the area also. At the time of the Exposure Draft 64 (ED 64) discussions during the development of IAS 40, a number of respondents, especially from the UK, argued against charging non-permanent gains and losses on investment property to income. Such disagreements and discussions go beyond the accounting for investment properties, and to the heart of questioning what the profit and loss account statement should show, and the basis on which profit should be calculated.

#### **Accounting issue: Cost or fair value valuation of investment properties**

The final area of interest when one compares accounting for investment properties under ASB and IASB frameworks concerns allowable treatments. SSAP 19 is clear in recommending that property qualifying as investment property should be valued at open market value. No other treatment is allowable. However, IAS 40 allows investment property to be valued at either cost or fair value, but one method must be applied consistently across all such property held. None of the allowable options in IAS 40 are described as 'benchmark' treatments,

which appears to support the idea that the IASB is undecided on the model to follow. During the time of ED 64, the Board was faced with views that certain property markets were not sufficiently mature for a fair value model to work satisfactorily. Furthermore, other views believed that it is impossible to create a rigorous definition of investment property and that this made it impracticable to require a fair value model at the current time. For these reasons, in IAS 40 the IASB believed it impossible to require a fair value model for investment property. However, they also believed it desirable to permit a fair value model:

‘This evolutionary step forward will allow preparers and users to gain greater experience working with a fair value model and will allow time for certain property markets to achieve greater maturity.’<sup>27</sup>

This statement clearly illustrates one of the limiting factors that the international accounting standard programme faces. It has to cater for all market conditions throughout the globe, while the ASB is setting standards for the mature UK market. As such, ASB standards can be more proactive than IASB standards, and by being so, they are more suited to the UK accounting arena. It remains to be seen if the IASB eventually withdraws the cost model option for investment property. As the matter stands, international comparability, the aim of EU adoption, will suffer.

### **Accounting issue: Revenue recognition**

Revenue recognition in the accounts of UK companies is an area that is currently under review by the ASB. Following recent criticism by both UK investors and the London Stock Exchange of inap-

propriate revenue recognition, both the ASB and the Audit Practices Board (APB) have issued discussion papers on the issue. There is at present no accounting standard in the UK that contains specific requirements for how revenue is to be defined and recognised. Faced with difficult questions over revenue recognition, different companies have found different answers, and practices have developed that are in some respects inconsistent both between and within industries. For their guidance, UK accountants have to rely on their own judgment, the fundamental accounting principles contained in the earlier SSAP 2 and the newly issued FRS 18 Accounting Policies, and the ASB’s Statement of Principles.

Despite the UK position, there is an existing International Accounting Standard that deals with revenue issues, IAS 18 Revenue. IAS 18 has even been used in the UK as a source of guidance. However, it is not always clear how its application rules are derived from underlying principles. The IASB is expected to assign revenue recognition a high priority within the Conceptual Framework section of its forthcoming agenda.

The ASB has stated that it aims to develop a robust framework, in consultation with the IASB and other standard setters, that can ultimately be the basis for an accounting standard dealing with general revenue principles. National standard setters have thus already agreed to liaise with the IASB in order to develop a convergent approach to revenue recognition.

Wilson Connolly, the UK house-builder, is a prime example of how UK properties companies are struggling to interpret and apply the present revenue recognition rules. When declaring its six-monthly results to 30th June 2001,<sup>28</sup> the company announced plans to adopt a more conservative accounting policy for

house sales, recognising a transaction on legal completion rather than on exchange of contracts. This change effectively delays the recognition of revenue in the profit and loss account and eliminates the possibility of customers pulling out before completing.

### Accounting issue: Lease accounting

Apart from the issue of certain leasehold investment properties, the basic treatment of leases is very similar in SSAP 21 (coupled with FRS 5) and IAS 17 (coupled with SIC 15 and SIC D27), being classified as either operating or finance. Both apply the economic ownership concept, and try to avoid the problem surrounding the concept of legal ownership. However, the IAS 17 definition of a finance lease does not include a rule similar to the 'rule of 90 per cent' of SSAP 21. IAS 17 simply states that in order for a lease to be accounted for as a finance lease the present value of the minimum lease payments must be greater than, or equal to *substantially all* of, the fair value of the leased asset. The use of 'substantially all' rather than a specific percentage is the IASB's attempt at circumventing the UK's problem of having companies who deliberately construct the terms of the lease to prevent it being deemed a finance lease. Whether this is any more successful is open to question.

Aside from the problem surrounding lease definition, one of the biggest incompatibilities between UK and international lease standards surrounds the extremely topical area of sale and leaseback transactions. SSAP 21 requires that any profit or loss on a sale and leaseback transaction that results in a finance lease should be deferred and amortised over the shorter of the lease term and the asset's useful life. IAS 17 requires that such a profit (but not a loss) should be deferred and amortised

only over the period of the lease term. However, what makes matters more complicated is that both of these approaches are incompatible with the requirements in FRS 5 Reporting the Substance of Transactions that, in a sale and repurchase agreement, the sale proceeds should be recognised as a liability and no profit should be recognised. As can be seen in the recent financial press, there are a growing number of UK companies involved in the sale and leaseback of their property; as a result, the ASB does need to act to conform the requirements of SSAP 21 with those in FRS 5. However, even if this does happen, the new rules will still be different from the requirement of IAS 17.

Another area of difference lies in the distribution of the finance income due to a lessor. IAS 17 requires that a lessor should recognise finance income so as to reflect a constant periodic rate of return on the lessor's *net investment* in the lease. In contrast, SSAP 21 requires the use of a method that reflects a constant periodic rate of return on the lessor's *net cash investment* in the lease (but allows the net investment method for hire purchase contracts). The reason behind the SSAP 21 approach is that the net cash investment in a lease can differ substantially from the net investment in a lease because of a number of other cash flows which affect the lessor, such as advance rental payments and the impact of capital allowances. Although the methods used by SSAP 21 and IAS 17 both result in the same total amount of finance income being charged to the profit and loss, they do allocate different amounts of income to each period covered by the lease. As a result, UK companies who are substantial lessors may experience a short-term impact on their profitability from any requirement to adopt the alternative leasing rules contained within IAS 17.

Apart from the methodology differences noted above, IAS 17 also requires lessees and lessors to provide a considerably greater number of accounting disclosures when compared to SSAP 21. It is beyond the scope of this paper to describe all of these additional disclosures in detail,<sup>29</sup> but taken together, they are aimed at giving a comprehensive picture of the current situation of each type of lease held.

As the authors indicated in a previous paper on lease accounting,<sup>30</sup> there are growing calls for a reform and revision to both international and UK accounting rules on lease accounting. Both the IASB and ASB are giving serious thought to addressing the issue of leases, and one of the final acts of the international G4 + 1 committee of national standard setters before it disbanded was to issue a discussion paper arguing for a fundamental revision to lease accounting.<sup>31</sup> This discussion paper should be the first step towards a greater level of convergence between the IASB and ASB rules governing lease accounting. By 2005, there may not be a need for UK companies to adjust to the requirements of IAS 17, as there could already be an internationally agreed standard in use by the ASB.

#### **Accounting issue: Long-term construction contracts**

Although accounting for long-term contracts is not an area relevant to property *per se*, it is obviously an important ancillary area that should be discussed. Current UK practice is contained in SSAP 9 Stocks and Long-term Contracts, while the relevant international accounting rules are contained in two standards: IAS 11 Construction Contracts and IAS 18 Revenue. Both SSAP 9 and IAS standards require the immediate recognition of expected losses. The IAS and SSAP 9 approaches also use a percentage of

completion method for the recognition and measurement of revenues, expenses and profits on construction contracts and other contracts for the rendering of service. Despite this apparent similarity, there does appear to be a crucial incompatibility in implementation. SSAP 9 requires that the 'prudently calculated attributable profit should be recognised'.<sup>32</sup> SSAP 9 also places more emphasis on the concept of prudence when assessing the stage of completion and variations on a contract. In contrast to the use of this rather vague and conservative-minded concept, the IAS standards rely instead on more 'objective' notions, such as probability and reliable measurement, when assessing both the profit and stage of completion on a contract.

The current emphasis on prudence within SSAP 9 seems to allow a greater level of discretion when accounting for long-term contracts, and as a result can permit a deliberate understatement of assets and contract gains. Surprisingly, it also contradicts the ASB's recently issued Statement of Principles,<sup>33</sup> which sees prudence as only one of the attributes that need to be present if financial information prepared under conditions of uncertainty is to be reliable. SSAP 9 was last revised in 1988, since when both the ASB and the IASB have accepted that inappropriate use of prudence can seriously affect the quality of the information provided. As a result, SSAP 2 Disclosure of Accounting Policies, the standard that contained the old view of prudence (that revenues and profit should not be anticipated, but recognised only when the ultimate cash realisation can be assessed with 'reasonable certainty'),<sup>34</sup> has been withdrawn and replaced by FRS 18 Accounting Policies. Within FRS 18, the use of prudence to deliberately understate results is no longer acceptable, and the concept is now seen as just one aspect of the overall objective



of reliability. To summarise, SSAP 9's current reliance on the concept of prudence is inconsistent with the ASB's new approach to financial reporting and will cause it to be reviewed in the near future. It is expected that the revised standard will adopt the more 'objective' approach of IAS 11 and 18 when accounting for elements of long-term contracts.

Apart from the issue of prudence, the ASB and IASB standards have a number of other differences regarding the guidance given on the balance-sheet presentation and treatment of different types of contract. SSAP 9 includes extensive guidance on the presentation of assets and liabilities arising from long-term contracts, such as work-in-progress, receivables and payables, while IAS 11 does not. In contrast, IAS 11 includes slightly different requirements for dealing with fixed-price and cost-plus contracts, while SSAP 9 does not make any such distinction. IAS 11 is also more detailed in specifying contract revenue and costs, in establishing what they should include and illustrating how they should be measured. Finally, IAS 11 requires extra accounting disclosures regarding the methods used to determine contract revenues and stages of completion, and also disclosure of the contract revenue recognised as revenue in the period.

In summary, SSAP 9 seems to be an accounting standard that is badly due for revision by the ASB. It would not be a surprise if any such revision followed both the approach and guidance contained within IAS 11 and IAS 18.

#### **Accounting issue: Value of property held as stock for resale**

IAS 2 Inventories (coupled with SIC 1 Consistency — Different cost formulas for inventories) and SSAP 9 Stocks and Long Term Contracts are the standards govern-

ing the treatment of property held as stock for resale. Under both standards, the methods of calculating stock values are comparable, as is the requirement to value stock at the lower of cost and net realisable value (NRV). IAS 2 offers a benchmark treatment of assignment for the cost of inventory by using the first-in first-out (FIFO), or weighted average cost (AVCO), formula. In addition, IAS 2 provides an allowed alternative treatment of assignment cost of inventory using the last-in first-out (LIFO) formula. In contrast, SSAP 9 specifically states that the use of LIFO is not usually appropriate because it results in balance-sheet amounts that bear little relationship to recent cost levels. As a result, SSAP 9 only allows the use of either FIFO or AVCO for assigning inventory cost. By allowing the use of LIFO, IAS 2 may allow companies to report lower profits in times of rising inventory prices and vice versa. However, the same formula should be applied consistently to all similar assets and across accounting periods (unless there is a valid reason for a change, such as a change following a take-over), thereby reducing the opportunity for creative accounting manipulation. Apart from the difference over LIFO, SSAP 9 and IAS 2 are largely consistent with each other.

#### **INTERNATIONAL STANDARD CONSULTATION AND FORMULATION: IASB AND EFRAG**

As stated in the authors' earlier papers,<sup>35</sup> involvement with the consultation processes that create these standards is worthwhile and results in the particular requirements of property assets and the profession being considered. However, unlike the British standards, the IASB<sup>36</sup> does not directly recognise corporate real estate professionals, valuers or IVS.<sup>37</sup> The International Valuation Standards Com-

mittee is not directly a part of the IASB. Consultation responses need to be aimed directly to the IASB.<sup>38</sup>

The IASB seeks to create a single set of clear, technically sound and enforceable accounting standards to ensure transparency and comparability for international investors. Its aim, like that of the EU described above, is primarily to promote rigorous application in financial statements for stewardship purposes. This is an important point, as it primarily places protection of investment rather than (say) value for security of bank loans as central to IAS.

The primary EU group responsible for involvement with IASB consultations is European Financial Reporting Advisory Group (EFRAG). Its Technical Expert Group, established 26 June 2001, will advise the EU on implementation of IAS, while an Accounting Regulatory Committee will operate at the political level under established EU rules for decision making by regulatory committees. EFRAG is aimed at unifying the EU's considerable economic and political power into a single voice within the creation process of IAS.

## CONCLUSIONS

For the EU, adoption of IAS serves simple and useful functions. They provide a solid reporting infrastructure and clear standards with few options for 'creative accounting'; are independent and will provide consistency across the Union; ensure high-quality audit; and are enforced by adequate sanctions. Such is the EU dream. It remains to be seen in exactly what form the EU's adopted IAS will operate by 2005. In accounting and financial reporting terms, 2005 is far into the future and much may yet happen within the intellectual debates that underpin the standards. It is impos-

sible to predict what financial accounting and political issues will occur before that time.

History suggests that such attempts are doomed to failure as national issues rise against moves towards harmonisation. It is certainly plausible that this latest EU attempt to converge accounting practice will result in the same 'political fix' as happened at the time of the Fourth Directive. Only time will tell. However, should the directive be successfully implemented, then the EU will clearly have a very powerful voice within the debates concerning the development of IAS. It is also very clear not only that corporate real estate advisers need to be aware of these debates, but also that they must become involved in them. As with the issues discussed with reference to British standards,<sup>39</sup> IAS have the potential to alter the reported performance of UK companies holding property assets. The profession needs to be involved in creating and amending standards to reflect these interests, and needs to do so via the auspices of the IASB.

## REFERENCES

- (1) Vol. 3, No. 2, pp. 132–149; Vol. 3, No. 3, pp. 232–247.
- (2) Both published by International Thomson Business Press, London.
- (3) The authors' earlier papers within this journal were: Eccles, T. and Holt, A. (2001a) 'Accounting for Property in the UK: The Legal and Professional Framework', *Journal of Corporate Real Estate*, Vol. 3, No. 2, pp. 132–149; Holt, A. and Eccles, T. (2001b) 'Accounting for Leasehold Property in the UK: A Triumph of Substance over Form?', *Journal of Corporate Real Estate*, Vol. 3, No. 3, pp. 232–247. In addition, the authors have considered other relevant issues within: Eccles, T. and Holt, A. (2001) 'Accounting for

- Investment Properties in the UK: Problems of Definition and Implementation', *Briefings in Real Estate Finance*, Vol. 2, No. 1, pp. 122–134; Eccles, T. and Holt, A. (2001) 'Accounting Standards and the Property Manager', *Journal of Property Management*, Vol. 19, No. 5, pp. 417–432.
- (4) See ref. 3 above.
- (5) To some extent this is reciprocated, since within its own work the IVSC acknowledges only the support of PricewaterhouseCoopers from the field of accounting, as evidenced by the acknowledgements in International Valuation Standards Committee (2000) *International Valuation Standards 2000*, IVSC, London, iii.
- (6) The International Accounting Standards Committee (IASC) became the IASB in April 2001. As of that date, its full-time standard-setting board consisted of Sir David Tweedie as chairman, five auditors, three preparers of accounts, three users, one academic and two 'other'.
- (7) At this time there are 15 national GAAPs (based upon EU directives), US GAAP is allowed in France, Germany, Austria, and Belgium; and there is a varied approach to the acceptance of IAS. For example, German firms tend to use IAS *in toto*, Italian firms when Italian GAAP does not offer advice upon a particular issue and Dutch firms 'where possible' — which usually equates to 'where they wish to'.
- (8) The precise EU documentation on the issues is as follows: Accounting Harmonisation: A new strategy vis-à-vis international harmonisation 11/95; Financial Services Action Plan 05/99; Lisbon European Council 03/00; EU Financial Reporting Strategy 06/00; Committee of Wise Men 02/01; Stockholm European Council 03/01.
- (9) It is worth noting that the IAS will be introduced with the most powerful form of EU legal instrument, that of *regulation*.
- (10) While the Parliament has power, in reality it would be unusual for it to ignore the Committee's decisions upon areas of intense technical detail.
- (11) EFRAG is an interesting 'grey area' within the EU legislative framework, since it is a private body and as such cannot be directly referred to by the democratic structures of the EU.
- (12) The EU Commission also considered using US GAAP as the basis for EU accounting convergence, but this could have potentially introduced a whole new set of political problems, especially after the EU Competition Commission recently blocked the merger of two US aerospace companies, Honeywell and GE.
- (13) 'The International Accounting Standards Survey 2000' appears in a number of alternative formats. Most up-to-date version and other information may be found at [www.cairns.co.uk](http://www.cairns.co.uk)
- (14) Deloitte Touche Tohmatsu (2001), *IAS Plus*, May edition.
- (15) For further details on the concept of IAS 'lite', see Cairns material, ref. 13 above.
- (16) Eccles, T. and Holt, A. (2001) 'Accounting for Property in the UK', ref. 3 above.
- (17) Compliance solely with the relevant IAS would not guarantee the UK legality of the accounts, as UK GAAP does differ from IAS GAAP in certain areas. This point will be developed later in the paper.
- (18) See ref. 3 above.
- (19) Holt, A. and Eccles, T. (2001) 'Accounting for Leasehold Property in the UK', ref. 3 above; Eccles, T. and Holt, A. (2001) 'Accounting for Investment Properties in the UK', ref. 3 above.
- (20) IASC (1990) *Statement of Intent on the Comparability of Financial Statements*, IASC, London.
- (21) Under both the ASB and IASB frameworks the selected method of accounting for an event or transaction should be applied consistently to all like events or transactions.

- (22) See FRS 15 paragraph 15.53.
- (23) IASC (1998) IAS 16 Property, Plant and Equipment, paragraph 6, IASC, London.
- (24) Companies Act 1985, Schedule 4, paragraphs 34(2), 48(4), 50(1), 50(3) and (50)(5).
- (25) See Holt and Eccles (2001) 'Accounting for Investment Properties in the UK', ref. 3 above.
- (26) See the paper on investment properties, ref. 3 above, for a further discussion of the distinction between realised and unrealised gains.
- (27) IASC (2001) IAS 40 Investment Property, Appendix B, paragraph B48, IASC, London.
- (28) 'Wilson Connolly Takes Accounting Charge', *Financial Times*, 3 July 2001, p. 34.
- (29) The additional disclosures of IAS 17 are outlined in Cairns, D. and Nobes, C. (2000) 'The Convergence Handbook', ASB, London, pp. 59–60.
- (30) Holt, A. and Eccles, T. (2001) 'Accounting for Leasehold Property in the UK', ref. 3 above.
- (31) For further details on this project please see the paper on lease accounting, ref. 3 above.
- (32) ASB (1988) SSAP 9 Stocks and Long Term Contracts, ASB, London, para. 29.
- (33) ASB (1999) Statement of Principles, ASB, London.
- (34) ASB (1971), SSAP 2 Disclosure of Accounting Policies, ASB, London.
- (35) See ref. 3 above.
- (36) See ref. 6 above.
- (37) It is true that the IVSB points to the adoption of IAS 40 on a similar basis (and some identical wording) to its own requirements as proof of its participation in IAS creation. However, the fact that this is the sole example argues the opposite, and there is no formal recognition by the IASB. IVSC would need to trumpet this success much less loudly if it were playing a major role in all relevant standards.
- (38) Of course, this is not to suggest that consultation should not take place through the auspices of the IVSC. However, the issue to remember is that IAS are created by the IASB, a device representing a purely accounting conceptual framework. The IVSC, RICS and similar bodies will consult on their group responses to proposals. However, in contrast to the Accounting Standards Board (ASB), there is no formal recognition of valuation concepts or requirement to use valuer methodology, such as the requirement within FRS 15, to use the Red Book.
- (39) As outlined in ref. 3 above.