Classification of Real Estate Properties

The first determination to be made by real estate entities adopting IFRS is the classification of their real estate. The classification of real property will determine the available accounting options for their subsequent measurement. Typically, real estate entities will have one or more of the following classes of real property:

- **Investment Property**: is defined as real estate held to earn passive rental income or capital appreciation, and generating cash flows largely independently of the other assets held by the entity. IFRS has a distinct standard addressing investment property, and it allows a choice of using either the fair-value model or the cost model to account for such properties.

- **Property, Plant, and Equipment (PPE)**: comprises property held by the owner for use in the production or supply of goods or services, or for administrative purposes. Depending on the exact nature of other services provided, other owners of real estate such as hotels and seniors’ residences may be required to classify their investments as PPE. IFRS requires entities to account for PPE using the cost model, unless fair value can be measured reliably, in which case the revaluation model may be used.

- **Inventory**: would comprise property held by a real estate entity for sale in the ordinary course of business or in the process of development for sale (e.g., condo units or houses). Inventories are required to be recorded at the lower of cost and net realizable value.

- **Investment Property and PPE held for sale**: represents property that management intends to sell, but, unlike inventory, the sale of such property is not in the ordinary course of business. IFRS 5 requires assets held for sale to be accounted for at the lower of cost and fair value less cost to sell.

Currently, many real estate executives criticize the lack of market value information reflected in the financial statements. No longer! Upon adoption of IFRS, real estate entities will have the option to record their investment property using the fair-value approach.
model. Under this model, the carrying value of the property is adjusted each reporting period to its fair value, with all changes in fair value reflected immediately in profit or loss. With the fair value model, investment property is not depreciated and impairments are not assessed, as essentially the property is “marked to market” each period. The decision on which reporting model to use should not be taken lightly as it may have business implications beyond financial statement reports, and once an entity chooses the fair-value model, it is unable to revert back to the cost model. Each situation should be carefully analyzed, with professional advice if necessary, before making the important decision between the fair-value model and the cost model.

**Fair-Value Model**

The adoption of the fair-value model for investment property will require the support of the entire organization. A cost/benefit analysis should be considered when making the decision. Considerations include:

- Who will perform the fair-value calculation?
- Are the in-house resources and knowledge to determine fair value each reporting period and/or processes to support external appraisers available?
- If external appraisers are used, what will be the cost?

In addition to logistical and cost issues, the decision to adopt the fair-value model could have other business implications. For example, using the fair-value model will result in significant fluctuations in net income arising from the unrealized appreciation/depreciation in fair value of investment property being recognized each period. This may create challenges in maintaining certain key performance indicators and, ultimately, may require modification of external debt covenant requirements, internal bonus arrangements, or trust indentures, among others.

**Cost Model**

The cost model may appear to be the status quo of current Canadian GAAP; however, committing to this model on adoption of IFRS also presents unique challenges. First, IFRS requires a more stringent approach to componentization than the current practice in Canada. Componentizing assets may result in significant GAAP difference, depending on your current practice, and it may present some practical challenges with reconstructing cost information.

Second, IFRS provides additional choices in the first-year of its adoption. On adoption of IFRS, real estate entities may make a one-time election to record individual items of PPE and investment property at fair value, thereby avoiding the requirement to determine the historical cost of each component. However, in making the election, the adjustment to the carrying value of the assets is increased with a corresponding adjustment to opening retained earnings. Increased carrying values will reduce post changeover earnings by increasing depreciation charges, reducing future gains on disposal, and leaving more asset value exposed to future impairments. Foregoing this elective option may result in additional conversion efforts to identify and determine the historical cost of each material component. Regardless of the methodology used in year 1, it is likely that additional general ledger accounts and amortization policies will be required on a go-forward basis. Since IFRS is to be adopted on a retroactive basis, this should be kept in mind for current capital projects, to avoid losing information that may be difficult to reconstruct when IFRS is adopted.

Third, entities with investment property recorded under the cost model are still required to disclose the fair value of their real estate in the notes to the financial statements. As a result, significant effort will still be required to calculate the fair value of the property each reporting period.
Revaluation Model

IFRS provides entities holding PPE the option to annually “revalue” PPE’s carrying value to fair value. Under this model, unlike the fair value model for investment property, increases in fair value are reflected in equity (not in profit or loss) and amounts are never recycled through profit or loss. Under this method, entities continue to depreciate their assets. If entities choose to revalue their real estate, increases in fair value are recorded through equity with decreases to be first used to eliminate any unrealized gains previously recorded within equity and then included in the income statement for any excess.

Real Estate Inventory

Accounting for real estate inventory under IFRS is similar to Canadian GAAP, with one major exception: the ability to capitalize interest is based on a more prescriptive standard. Interest costs may only be capitalized to a property when an entity incurs expenditures for the asset, incurs borrowing costs, and begins development to prepare the asset for its intended use or sale. As a result, borrowing costs on land held for development may not qualify. Further, borrowing costs must cease being capitalized to a project in cases of extended delays in development or once the property is substantially complete for its intended use, regardless of level of occupancy.

Investment Property and PPE Held for Sale

Under IFRS, similar to Canadian GAAP, real estate held for sale is measured at the lower of the carrying amount and fair value less costs to sell, and is no longer amortized from the date of transfer. The primary difference between IFRS and Canadian GAAP relates to the definition of discontinued operations. Under IFRS, discontinued operations are currently limited to those operations that represent a separate major line of business or geographical area. It is generally assumed that individual properties held for sale would not meet the definition and, therefore, not require separate presentation on the income statement and balance sheet.

An exposure draft was recently issued to change the definition of discontinued operations to an operating segment. The proposed standard would more closely align with current Canadian GAAP if adopted.

Provisions

Under IFRS, a provision is recognized for a legal or constructive obligation when it arises from a past event, the outflow of resources is probable, and the amount can be estimated reliably. In this context, “probable” means “more likely than not” and represents a lower recognition threshold than “likely,” as used under Canadian GAAP. More items may therefore need to be provided for under IFRS.

Under IFRS, provisions are measured based on management’s best estimate of the amount required to settle the obligation. When a range of estimates exists, and no single estimate within the range is better than another, the obligation is measured at the midpoint of the range. A range of estimates is often encountered with legal claims. Discounting is also required on all provisions where the effect of the time value of money is material. The discount rate should reflect current market assessments of the time value of money and the risks specific to the liability. Provisions must be remeasured when discount rates change.

Impairment of Assets

IFRS has one impairment model covering PPE, investment property, goodwill, and intangible assets. Assets are evaluated either individually or grouped in a cash-generating unit (CGU) for impairment-testing purposes. A CGU is the smallest group of assets that generates independent cash inflows. It may be smaller than an asset group or a reporting unit under
current Canadian GAAP. For real estate entities, a CGU could be as low as an individual property. Assets are tested, and any resulting impairment charges are measured using a one-step test that compares an asset’s or CGU’s carrying value to its recoverable amount. Recoverable amount is the higher of the fair value less cost to sell (a market-based model) and its value in use (an entity specific model). Since IFRS requires that discounting be factored in when assessing impairment, and impairment is often evaluated in smaller “asset groups,” entities are more likely to have impairments under IFRS. Further, impairment losses associated with PPE, investment property, and intangible assets are reversed in subsequent periods if the circumstances that led to the impairment have changed. When an entity adopts IFRS, it may therefore need to reverse prior-year impairment losses and review for further impairment.

How Can KPMG Help?
KPMG is a leading provider of services to the real estate industry. Our real estate team consists of audit, tax, and advisory professionals dedicated to serving the real estate industry. Our experience has allowed us to develop the unique perspective and valued services required to help our clients thrive in a highly competitive marketplace.

KPMG has helped many organizations assess the impact of IFRS and implement it. We have an established conversion methodology that incorporates the different disciplines critical to a successful implementation. KPMG’s IFRS Conversion Services teams are multidisciplinary teams comprised of professionals knowledgeable in IFRS and Canadian GAAP, and skilled in financial reporting processes and financial integration. Our teams are supported by internationally trained professionals with global experience in both converting to and applying IFRS.

For a full description of our Conversion Services, refer to our publications Managing the Transition to IFRS: The Journey to 2011 and Managing the Transition to IFRS: Clearing the Path to 2011, available at www.kpmg.ca/ifrs.

To learn more about our IFRS Conversion Services for real estate entities, please contact your local KPMG office or:

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