IAS 40 - QUESTION

Investors Galore Inc., a listed company in Germany, ventured into construction of a mega shopping mall in south Asia, which is rated as the largest shopping mall of Asia. The company‟s board of directors after market research decided that instead of selling the shopping mall to a local investor, who had approached them several times during the construction period with excellent offers which he progressively increased during the year of construction, the company would hold this property for the purposes of earning rentals by letting out space in the shopping mall to tenants. For this purpose it used the services of a real estate company to find an anchor tenant (a major international retail chain) that then attracted other important retailers locally to rent space in the mega shopping mall, and within months of the completion of the construction the shopping mall was fully let out.

The construction of the shopping mall was completed and the property was placed in service at the end of 20X1. According to the company‟s engineering department the computed total cost of the construction of the shopping mall was $100 million. An independent valuation expert was used by the company to fair value the shopping mall on an annual basis. According to the fair valuation expert the fair values of the shopping mall at the end of 20X1 and at each subsequent year-end thereafter were

20X1	$ 100 Million
20X2	$ 120 Million
20X3	$ 125 Million
20X4	$ 115 Million

The independent valuation expert was of the opinion that the useful life of the shopping mall was 10 years and its residual value was $10 million.

Required

What would be the impact on the profit and loss account of the company if it decides to treat the shopping mall as an investment property under IAS 40

(a) Using the “fair value model”; and

(b) Using the “cost model.”

(Since the rental income for the shopping mall would be the same under both the options, for the purposes of this exercise do not take into consideration the impact of the rental income from the shopping mall on the net profit or loss for the period).

IAS 40 - SOLUTION

(a) Fair value model

If the company chooses to measure the investment property under the fair value model it will have to recognize in net profit or loss for each period changes in fair value from year to year. Thus the impact on the profit and loss account for the various years would be

Year	Cost $ Millions	Fair Value $ Millions	Profit & Loss A/C $ Millions	
20X1	100	100	0	Cost is equal to Fair Value therefore no gain no loss
20X2		120	20	Fair Value Change (120 - 100) = 20 gain in profit & loss recognized
20X3		125	5	Fair Value Change (125 - 120) = 5 gain in profit & loss recognized
20X4		115	-10	Fair Value Change (115 - 125) = 10 loss in profit & loss recognized

(b) Cost model

If the company decided to measure the investment property under the cost model it would have to account for it under IAS 16 using the cost model prescribed under that standard (which requires that the asset should be carried at its cost less accumulated depreciation and any accumulated impairment losses). Therefore, when investment property is measured under the cost model, the fluctuations in the fair value of the investment property from year to year would have no effect on the profit and loss account of the entity. Instead, the annual depreciation which is computed based on the acquisition cost of the investment property will be the only charge to the net profit or loss for each period (unless there is impairment which will also be a charge to the net profit or loss for the year).
Based on the acquisition cost of $10 million (assuming there is no subsequent expenditure that would be capitalized), a residual value of $10 million, a useful life of 10 years, and using the straight-line method of depreciation, the annual impact of depreciation on the net profit or loss for each year would be

20X1	$ (100 – 10)/10 million	= 9 million
20X2	$ (100 – 10)/10 million	= 9 million
20X3	$ (100 – 10)/10 million	= 9 million
20X4	$ (100 – 10)/10 million	= 9 million