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Determining the Fair Value of Investment Properties in the Absence of Valuation Obtained from a Qualified Valuer

Kaushalya. M. D. P[1]

[1]Department of Accountancy, University of Kelaniya, Sri Lanka

Abstract: ***In consequence to introduction of Sri Lanka Accounting Standards (SLFRS and LKAS) compatible with International Financial Reporting Standards (IFRS), by The Institute of Chartered Accountants of Sri Lanka effective from 1st January 2012, The Company being a registered finance company with public accountability, is required to apply provisions of the full set of SLFRS/LKAS consisting 09 SLFRSs, 29 LKASs and 15 IFRICs. Accordingly, the financial statements for the year ended 31st March 2013 are the first set of financial statements prepared by this company compatible with the Sri Lanka Accounting Standards and therefore in the preparation of these financial statements company had encountered lot of issues regarding the deviations from the requirements of the accounting standards. Out of them, in this report I have discussed in detailed one of the main issues that were identified during the preparation of financial statements of this company. From this year onwards the company is going to adopt the fair value model for the subsequent measurement of investment properties. Then the issue was the determination of fair value of investment property in the absence of valuation by a qualified valuer. In such situation discounted future cash flow method is permitted by the accounting standards and how it can be done is also explained in this case study report.***

Keywords: Sri Lanka Accounting Standards, Investment Property, Fair Value

1. Introduction

The company is currently using cost model for the subsequent measurement of the investment properties. But with the convergence of the financial statements to SLFRS, the company is going to change its policy on the subsequent measurement of investment properties to measure at the fair value.

Because this is a change in a company accounting policy, retrospective application of the policy is required according to Sri Lanka Accounting Standard (LKAS) 08 - “Accounting policies, changes in accounting estimates and errors”. Accordingly in addition to the current year figures, 01st April 2011 and the 31st March 2012 figures in the financial statements also need to be restated to compatible with the new accounting policy.

This company owns a condominium building categorized under investment property which is located in Colombo. The issue arose here is, there are some blocks of this condominium building which are included in the current year valuation report but not in the previous year valuation reports. The reason is, in last year company has denied to recognize some blocks in the financial statements saying that those blocks have a claim by their related company without providing any legal documents to prove it. Therefore the last year audit report also qualified on that issue.

But now the management of the company has agreed to recognize those blocks in the financial statements. From this year because the company is going to adopt the fair value model, how the fair value of these blocks are restated in the financial statements (i.e. 2011/12 figures) is a problem encountered by the company.

2. Implication

In LKAS 40, it is clearly mentioned that if a company selects the fair value model to measures its investment properties, all the properties must be categorized under it should be valued at fair value and part of them cannot be measured at cost. The related paragraph is extracted below.

“After initial recognition, an entity that chooses the fair value model shall measure ***all*** *of its investment property at fair value.”****(Paragraph 33 – LKAS 40)***

Therefore if the company is unable to determine the fair value of these blocks and present them at cost, then it will be a violation of complying with an accounting standard and it will also dilute the reliability of the financial statements. At the same time because it is affected to the true and fair view of financial statements, it can also adversely affected to the audit opinion of the auditors.

3. Recommendation

In order to overcome this problem, company can implement few alternatives based on Sri Lanka Accounting Standard (LKAS) 40. In this standard, it is mentioned that to determine the fair value of an investment property, a qualified valuer is not always essential as follows, *“An entity is* ***encouraged, but not required*** *to determine the fair value of the investment property on the basis of a valuation by* ***independent valuer*** *who holds a recognized and relevant professional qualification and has recent experience on the location and category of investment property being valued”.* ***(LKAS 40 –Paragraph 32)***

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Therefore the company has freedom to determine the fair value of the investment properties using an appropriate basis. Then next problem is, what is the basis that the company should use to determine the fair value? Based on LKAS 40, it is recommended to measure the fair value using the discounted cash flow method, because in the absence of the active market price, it has been permitted to use discounted cash flows to determine the fair value of the properties as follows.

"In the absence of current prices in an active market for similar property in the same location and condition and subject same lease and other contracts, an entity may consider information from variety of sources, including;

- ***"Discounted cash flow predictions** based on reliable estimates of the future cash flows, supported by the terms of any existing lease and other contract and by external evidence such as **current market rents** for the similar properties in the same location and condition, and **using discount rates** that reflects the current market conditions"**(LKAS 40 – Paragraph 46)*** Accordingly a calculation of one of the blocks which we measured the fair value using this method as a specimen calculation, assist to the accounting personnel of the company is attached in **annexure 01**. Hence the future work will be to examine the ways to determine the fair value of a investment property in a situation where even the discounted cash flow method in impracticable.

Annexure 01

Calculation of the fair value of a block in the condominium building using discounted cash flow method for which a valuation by a qualified valuer is not available:

Block No. 15 – First Floor

Estimated monthly rentals		Rs. 160,000
Gross annual rent (Rs. 160,000x12)		Rs.1,920,000
Less: 33.33%		Rs. 640,000
Net annual rent		Rs.1, 280,000
Cumulative discount factor		
@ 8%for 61 years		12.3857
		Rs.15, 853,691
Fair value of the block		
(Approximately)	**Rs.**	**15,000,000**

Note:

01. Obtained the estimated monthly rental of the block based on the current rent agreement for the same block with a customer of the company.
02. Deducted 33.33% of the annual rent income in determining the future cash flows because the company has to bear the expenses like rates, repairs, taxes and insurance for the blocks owned by it.
03. Used 61 years cash flows, because the in the new valuation report (for the year ended 31.03.2013) qualified valuer has estimated that the useful life of this condominium property as 60 years and therefore we added another one year because we are going to calculate the fair value for the year ended 31.03.2012.
04. Discounted expected future cash flows at 8%, because the current Treasury bill rate (03 months) in Sri Lanka is around 8%.

References

[1] Sri Lanka Accounting Standard – LKAS 08 (Accounting Policies, Changes in Accounting Estimates and Errors).
[2] Sri Lanka Accounting Standard – LKAS 40 (Investment Properties)

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