

In depth

IFRS 9 impact on the Real estate industry

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Application of IFRS 9 in the real estate industry

At a glance

IFRS 9 will impact the real estate industry and, with an effective date of 1 January 2018, it is here now. Real estate entities hold a number of financial instruments arising from their core operations (lease and trade receivables), from risk management activities (foreign exchange and interest rate hedges), or cash management and investing activities (debt and equity investments). All financial assets need to be carefully assessed, to understand the classification and impairment implications.

IFRS 9 replaces the majority of IAS 39; it covers classification, measurement, recognition and derecognition of financial assets and financial liabilities, and impairment of financial assets, and it provides a new hedge accounting model.

IFRS 9: Classification and measurement: PwC In depth INT2014-05, IFRS 9: Expected credit losses: PwC In depth INT2014-06 and IFRS 9: hedging in practice – Frequently asked questions: PwC In depth INT2015-05 provide a comprehensive analysis of the new standard. This In depth discusses some of the more significant impacts on entities within the real estate industry.

IFRS 9: What's new in financial instruments accounting for asset management: PwC In depth INT2018-06. This In depth discusses the impacts for the asset management industry and is equally relevant to the real estate industry.

What to do now?

Real estate 'to do' list:

Here is your immediate 'to do' list for the implementation of IFRS 9 (read the guide for more detail in each area):

1. **Equity investments** will ALL be held at fair value, even if they are unquoted. There is no cost exemption. An entity needs to decide if it will make an irrevocable election to hold any equity instruments at fair value through other comprehensive income. This can be done on an instrument-by-instrument basis. Note that this applies only to those investments in the scope of IFRS 9 that are equity instruments in the meaning of IAS 32 paragraph 11. Instruments that are puttable or that impose a requirement on an entity to deliver cash on liquidation are not equity instruments in the meaning of IFRS 9. [IFRS 9 para BC5.21].
2. The **impairment model** has changed and, in many cases, this will lead to a higher impairment provision. Entities need to work through the expected credit loss model, ensuring that expectations of forward-looking data are incorporated.
3. Where IFRS 9 is applied, all **hedging documentation** must be re-done to show how the new hedge accounting criteria have been satisfied.

Introduction – A snapshot of the financial position of a real estate company

A typical balance sheet of a real estate company might include the following financial instruments or receivables that fall under IFRS 9:

Non current assets



- Equity investments
- Loan receivables, including intercompany loans

Current assets

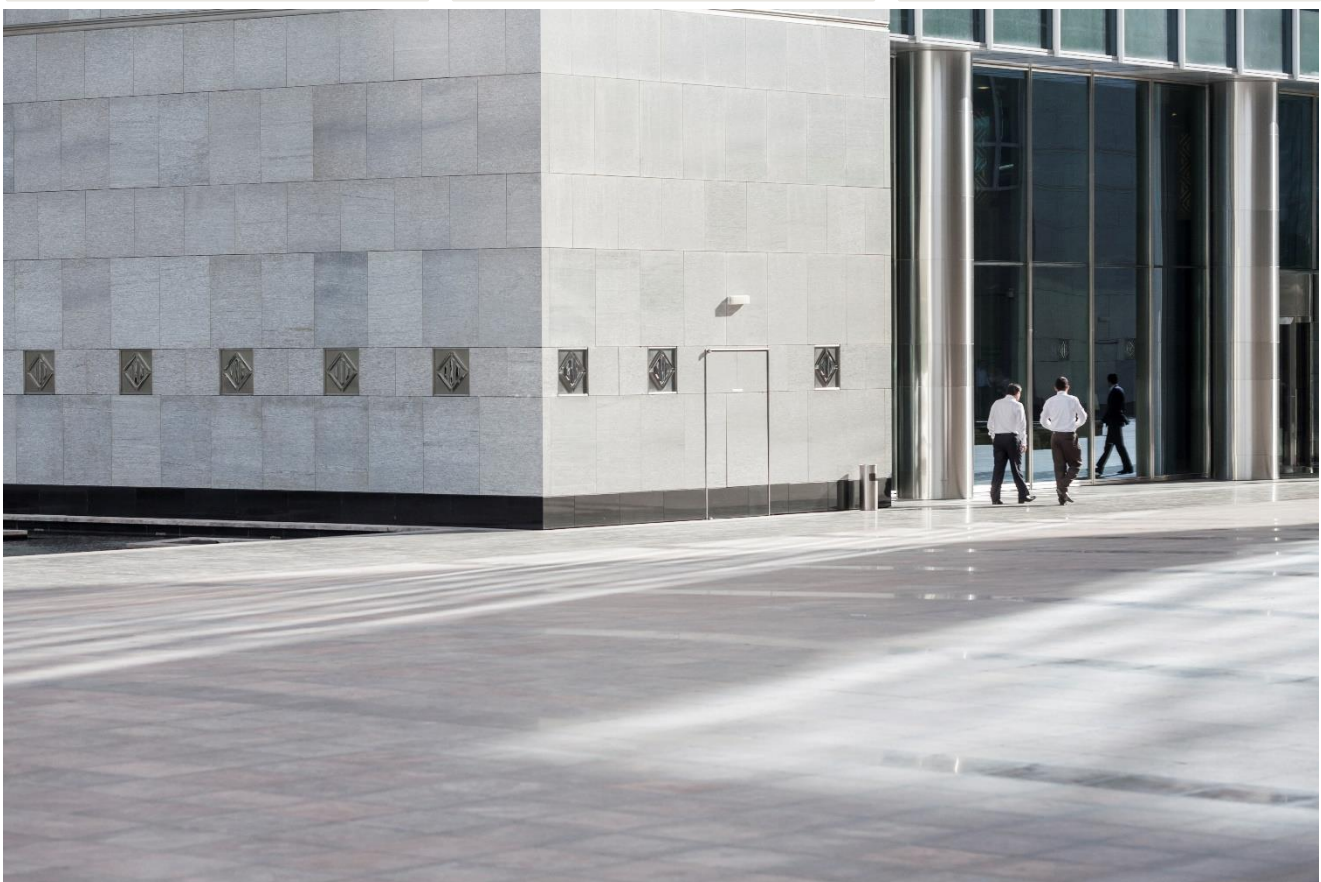


- Lease and trade receivables
- Derivative financial assets

Current and non current liabilities



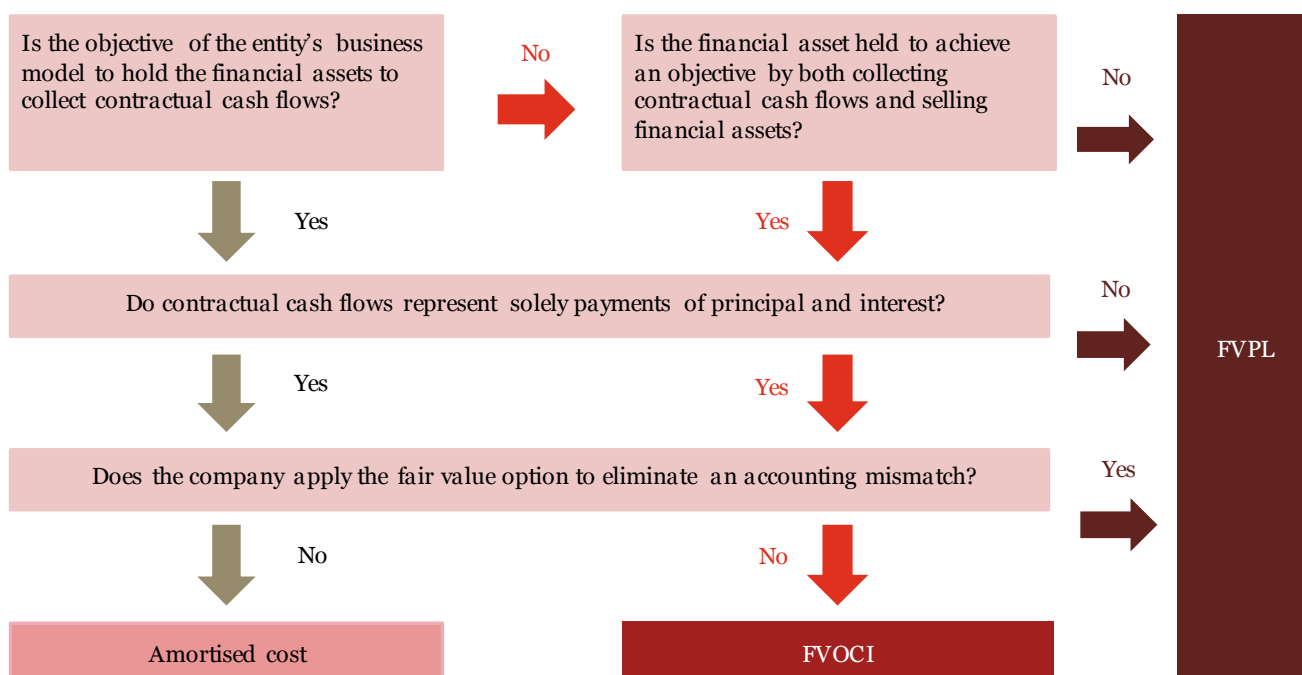
- Borrowings
- Derivative financial liabilities



Classification and measurement – Business model assessment

Debt investments (including receivables)

Classification under IFRS 9 of debt investments, is driven by the entity's business model for managing the financial assets and whether the contractual characteristics of the financial assets represent solely payments of principal and interest (SPPI).



Business model assessment

The classification and measurement of financial assets under IFRS 9 is determined based on two criteria:

- the business model within which the entity holds the asset (business model test), and
- the cash flows arising from the asset (SPPI test that is, the financial asset gives rise to cash flows that are solely payments of principal and interest).

The business model test will determine the classification of financial assets that pass the SPPI test.

IFRS 9 makes a distinction between three different business models:

- **Hold to collect:** The entity holds the financial assets in order to collect the contractual cash flows. The entity measures such assets at amortised cost.
- **Hold to collect and sell:** The entity holds the financial assets for both selling and collecting contractual cash flows. The entity measures such assets at fair value through other comprehensive income (FVOCI)
- **Hold to sell:** The entity holds the financial assets with an intention to sell them before their maturity. The entity measures such assets at fair value through profit or loss (FVPL).

In addition, note that if a financial asset is not held within 'hold to collect' or 'hold to collect and sell', it should be measured at FVPL – this is the residual category in IFRS 9. Further, a business model in which an entity manages financial assets, with the objective of realising cash flows through solely the sale of the assets, would also result in a FVTPL business model.

Contractual cash flows analysis

Management should also assess whether the asset's contractual cash flows represent solely payments of principal and interest ('the SPPI condition').

This condition is necessary for the financial asset, or group of financial assets, to be classified at amortised cost or FVOCI. 'Principal' and 'interest' are defined as follows:

- **Principal** is the fair value of the financial asset at initial recognition. However, that principal amount might change over the life of the financial asset (for example if there are repayments of principal).
- **Interest** is typically the compensation for the time value of money and credit risk.

However, interest can also include consideration for other basic lending risks (for example liquidity risk) and costs (for example, servicing or administrative costs) associated with holding the financial asset for a period of time, as well as a profit margin.

Equity investments

Investments in equity instruments (as defined in IAS 32, from the perspective of the issuer) are always measured at fair value under IFRS 9. The cost exception, under IAS 39 has been removed even for unquoted investments. In limited circumstances cost may be the appropriate estimate of fair value [IFRS 9 para B.5.2.3]. Although there are some circumstances in which cost might be representative of fair value, those circumstances would never apply to equity investments held by particular entities, such as financial institutions and investment funds.

Equity instruments that are held for trading are required to be classified at FVPL, with dividend income recognised in profit or loss. For all other equities within the scope of IFRS 9, management can make an irrevocable election on initial recognition, on an instrument-by-instrument basis, to present changes in fair value in other comprehensive income (OCI) rather than in profit or loss. Dividends are recognised in profit or loss unless they clearly represent a recovery of part of the cost of an investment, in which case they are recognised in OCI. There is no recycling of amounts from OCI to profit or loss (for example, on sale of an equity investment) nor are there any impairment requirements. There are additional disclosure requirements if an entity elects to measure equity instruments at FVOCI. [IFRS 7 paras 11A 11B].

No expected credit loss (ECL) provision is recognised on equity investments (see the section on ECL for debt measurement below.)

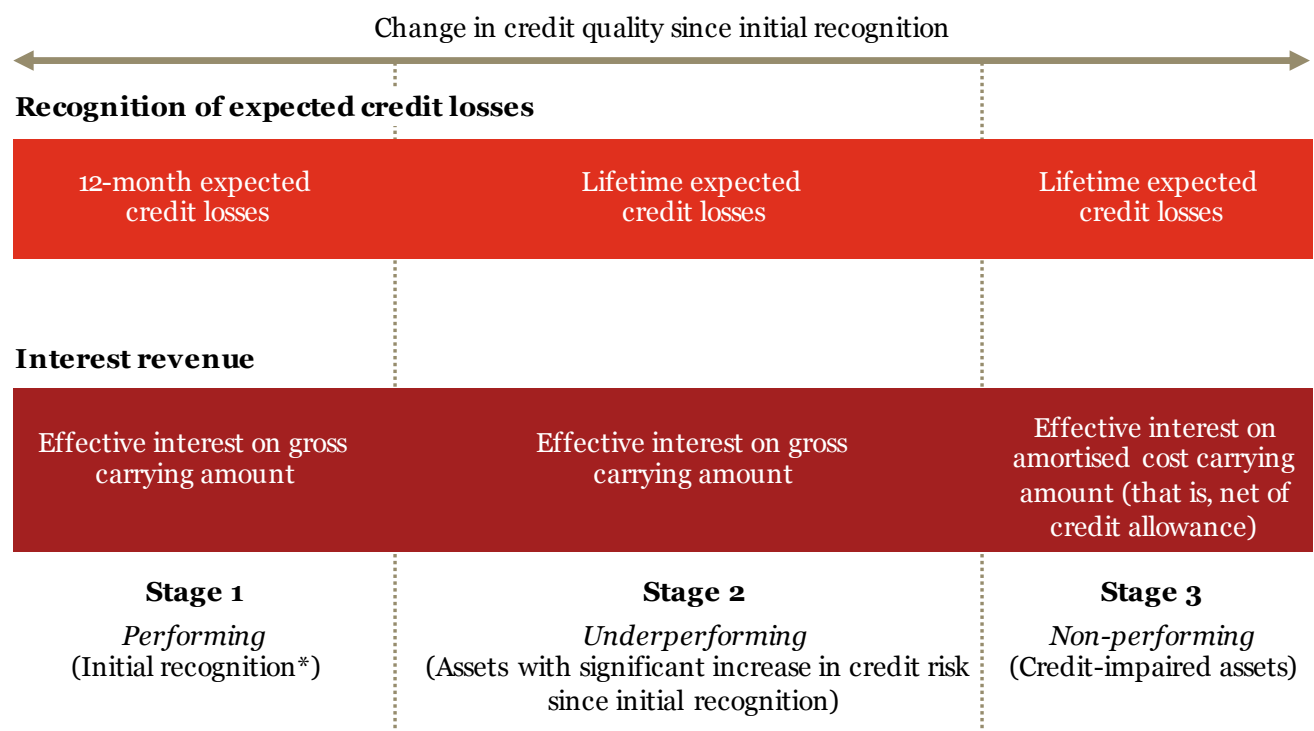


What does this mean for the real estate industry?

<p>Trade and lease receivables</p>	<ul style="list-style-type: none"> • Trade and lease receivables in a real estate entity will in principle meet the hold to collect criterion. The payments would normally comprise of solely of principal and interest. • As such, they would be measured at amortised cost.
<p>Equity investments</p>	<ul style="list-style-type: none"> • Equity instruments are measured at fair value under all circumstances. An entity can make an irrevocable election to measure equity investments at fair value through OCI. There are additional disclosure requirements if this election is used. No ECL is recognised for equity investments.
<p>Investments in bonds</p>	<ul style="list-style-type: none"> • For long term investments such as bonds the entity will need to assess the business model. • They might be classified at amortised cost, fair value through other comprehensive income or fair value through profit or loss.
<p>Derivatives</p>	<ul style="list-style-type: none"> • Derivatives remain classified at fair value through profit or loss.

Impairment of assets measured at amortised cost

The impairment rules of IFRS 9 introduce a new, forward looking, expected credit loss ('ECL') impairment model which will generally result in earlier recognition of losses compared to IAS 39.



- **Stage 1** includes financial instruments that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date. For these assets, 12-month ECLs are recognised and interest revenue is calculated on the gross carrying amount of the asset.
- **Stage 2** includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but are not credit-impaired. For these assets, lifetime ECL are recognised, and interest revenue is still calculated on the gross carrying amount of the asset.
- **Stage 3** consists of financial assets that are credit-impaired, (that is, where one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred). For these assets, lifetime ECL are also recognised, but interest revenue is calculated on the net carrying amount (that is, net of the ECL allowance).

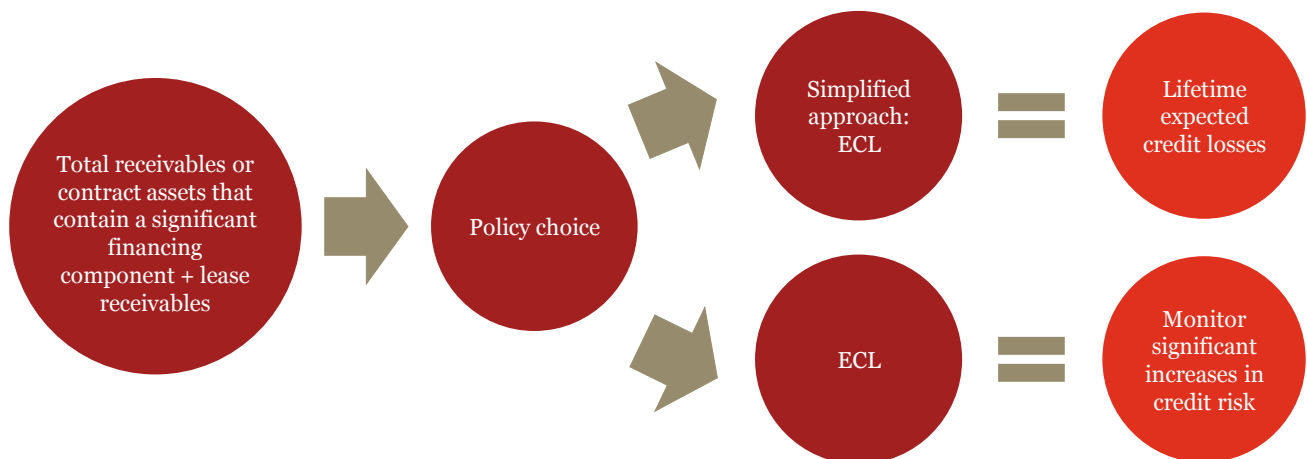
Impairment – Scope exception for trade and lease receivables: The simplified approach

The general impairment model includes some operational simplifications for trade receivables, contract assets and lease receivables, because they are often held by entities that do not have sophisticated credit risk management systems.

These simplifications eliminate the need to calculate 12-month ECL and to assess when a significant increase in credit risk has occurred.

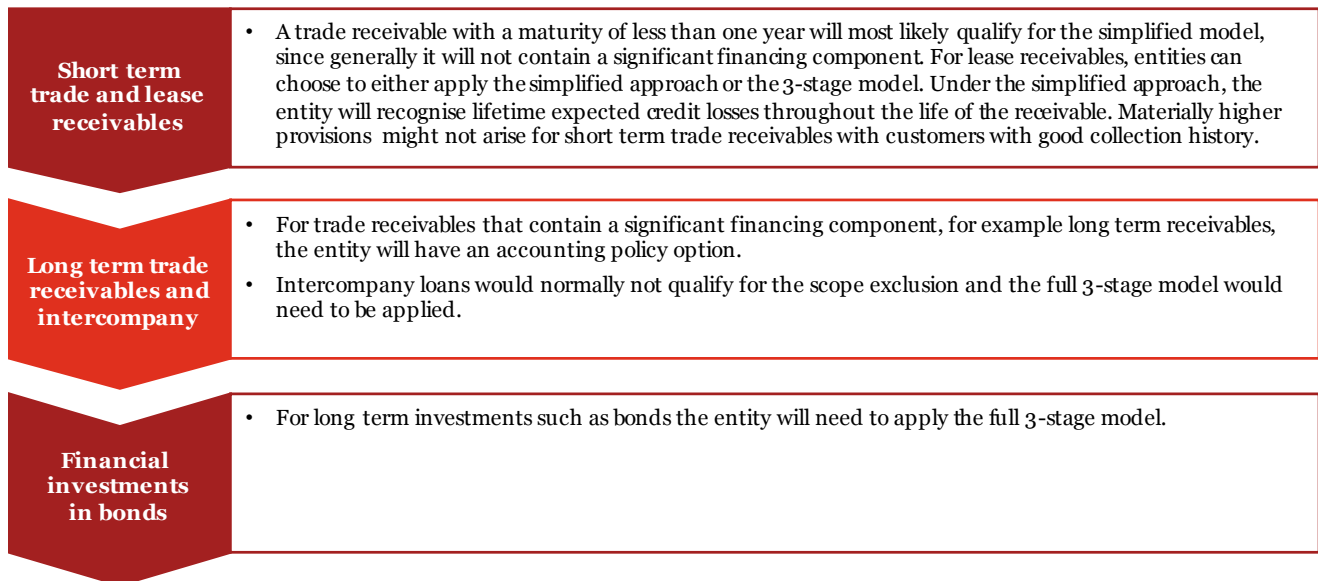
For trade receivables or contract assets that do not contain a significant financing component, the loss allowance should be measured at initial recognition and throughout the life of the receivable, at an amount equal to lifetime ECL. As a practical expedient, a provision matrix could be used to estimate ECL for these financial instruments.

For trade receivables or contract assets that contain a significant financing component (in accordance with IFRS 15) and lease receivables, an entity has an accounting policy choice: either it can apply the simplified approach (that is, to measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout its life), or it can apply the general model. An entity can apply the policy election for trade receivables, contract assets and lease receivables independently of each other, but it must apply the policy choice consistently.





What does this mean for the real estate industry?

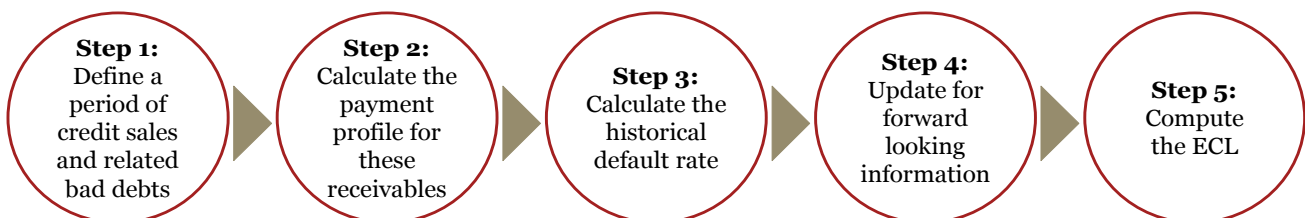


Provision matrix

IFRS 9 allows an operational simplification whereby companies can use a provisions matrix to determine their ECL under the impairment model.

How does a provision matrix work?

A provision matrix method uses past and forward information to estimate the probability of default of lease and trade receivables.



Step 1

The first step, when using a provision matrix, is to define an appropriate period of time to analyse the proportion of lease and trade receivables written off as bad debts. This period should be sufficient to provide useful information. Too short might result in information that is not meaningful. Too long might mean that changes in market conditions or the tenant base make the analysis no longer valid. In the example, we have selected one year and have focused on lease receivables. The overall lease receivables were CU10,000 and the receivables ultimately written off were CU300 in that period.

Total lease income	CU10,000
Bad debts written off out of this lease income	CU300

Step 2

In step 2, we determine the amount of receivables outstanding at the end of each time bucket, up until the point at which the bad debt is written off. The ageing profile calculated in this step is critical for the next step, when calculating default rate percentages.

Total lease income (CU)	10,000	Total paid	Ageing profile of lease income (step 3)
Paid in 30 days	(2,000)	(2,000)	8,000
Paid between 30 and 60 days	(3,500)	(5,500)	4,500
Paid between 60 and 90 days	(3,000)	(8,500)	1,500
Paid after 90 days	(1,200)	(9,700)	300 (written off)

Step 3

In this step, the entity calculates the historical default rate percentage. The default rate for each bucket is the quotient of the defaulted receivables at each bucket over the outstanding lease income for that period.

For example, in the above information, CU300 out of the CU10,000 lease income for the period, was written off.

Current lease income – historical rate of default

Since all of the receivables relating to the lease income for the period and those written off were current at some stage, it can be derived that for all current amounts, the entity might incur an eventual loss of CU300. The default rate would therefore be 3% (CU300/CU10,000) = For all current amounts.

Lease income outstanding after 30 days

An amount of CU8,000 was not paid within 30 days. An eventual loss of CU300 was a result of these outstanding receivables. Therefore, the default rate for amounts outstanding after 30 days would be 3.75%.

Remaining buckets

The same calculation is then performed for 60 days and after 90 days. Although the amount outstanding reduces for each subsequent period, the eventual loss of CU300 was, at some stage, part of the population within each of the time buckets, and so it is applied consistently in the calculation of each of the time bucket default rates.

The historical default rates are determined as follows:

	Current lease income	Lease payments outstanding after 30 days	Lease payments outstanding after 60 days	Lease payments outstanding after 90 days
Ageing profile of lease income (1)	10,000	8,000	4,500	1,500
Loss: (2)	300	300	300	300
Default rate: (2)/(1) (%)	3	3.75	6.67	20

Step 4

IFRS 9 is an ECL model, so consideration should also be given to forward-looking information.

Such forward-looking information would include:

- Changes in economic, regulatory, technological and environmental factors, (such as industry outlook, GDP, employments and politics);
- External market indicators; and
- Tenant base.

For example, the entity concludes that the defaulted receivables should be adjusted by CU100 to CU400 as a result of increased retail entity failures given their tenant base is primarily retail focused. The entity also concludes that the payment profile and amount of lease income are the same. Each entity should make its own assumption of forward looking information. The provision matrix should be updated accordingly.

The default rates are then recalculated for the various time buckets, based on the expected future losses.

	Current lease income	Lease payments outstanding after 30 days	Lease payments outstanding after 60 days	Lease payments outstanding after 90 days
Ageing profile of lease income (1)	10,000	8,000	4,500	1,500
Loss: (2)	400	400	400	400
Default rate: (2)/(1) (%)	4	5	8.9	27

Step 5

Finally, take the default rates from step 4 and apply them to the actual receivables, at the period end, for each of the time buckets. There is a credit loss of CU12 in the example illustrated.

	Total	Current (0-30 days)	30-60 days	60-90 days	After 90 days
Lease receivable balances at year end: (1)	140	50	40	30	20
Default rate: (2) (%)		4	5	8.9	27
Expected credit loss: (1)*(2)	CU 12	CU 2	CU 2	CU 3	CU 5

Intra-group loans

The scope for the accounting of intra-group loans and loans to joint ventures and associates ('funding') is not expected to change from the introduction of IFRS 9. Funding, previously within the scope of IAS 39, 'Financial instruments: Recognition and measurement' will also be within the scope of IFRS 9.

The impact of IFRS 9 on intra-group funding might often be dismissed, because it is eliminated on consolidation. However, the impact in separate financial statements could be significant.

Impairment of intra-group loans

Intra-group loans and loans to joint ventures and associates do not qualify for the simplifications in IFRS 9. The full impairment model needs to be applied, so 12-month ECL will be recorded on the day when funding is advanced.

Subsequently, if there is a significant increase in credit risk (for example, if the subsidiary's, joint venture's or associate's trading performance declines), the impairment loss will be increased to a lifetime expected credit loss.

What does this mean for Real Estate?

Intra-group funding and loans to joint ventures and associates with written terms would generally fall within the scope of IFRS 9. All requirements of IFRS 9 will therefore apply, including impairment.

Under IFRS 9, entities will be required to ensure that they implement adequate processes for collection of the information needed for impairment, for example:

- Indicators for a significant increase in credit risk must be developed.
- Forward-looking information, as well as past events must be incorporated.
- The contractual period over which to assess impairment may not be clear.

Cash advanced might not be fair value

Intra-group loans within the scope of IFRS 9 and loans to joint ventures and associates are required to be measured at fair value on initial recognition. These loans may sometimes be either interest-free or provided at below-market interest rates. In those cases, the amount lent is, therefore, not fair value.

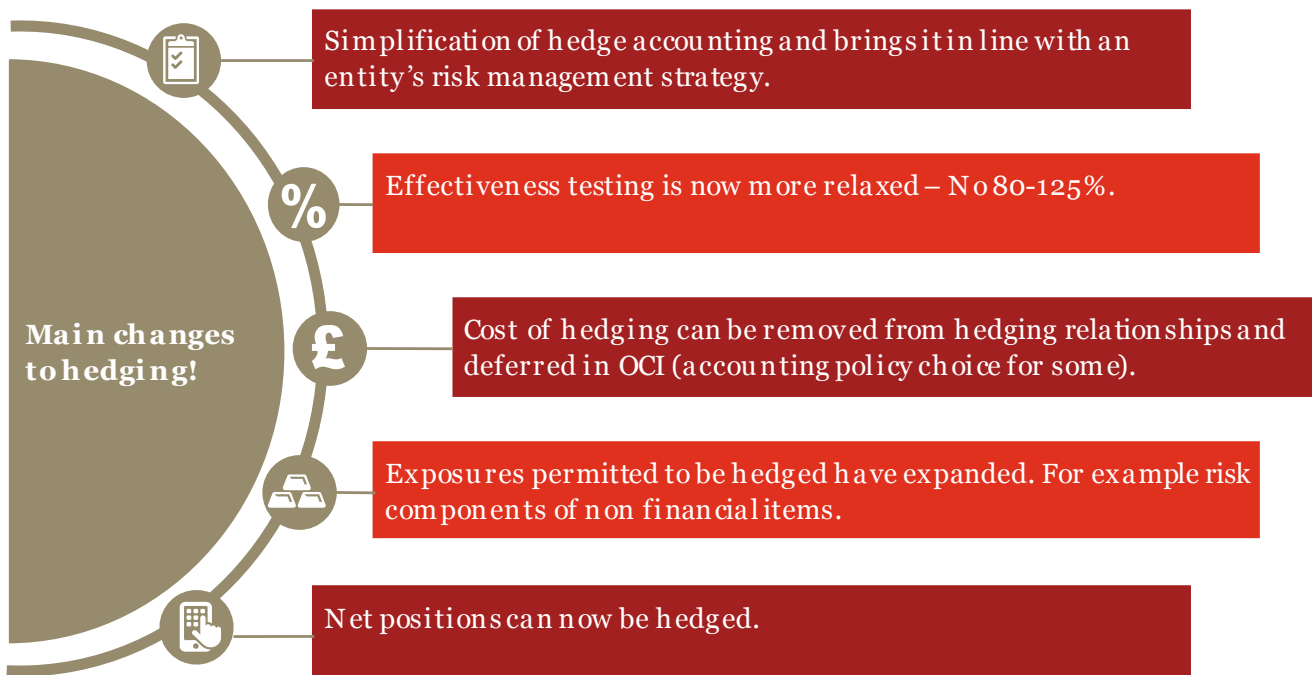
What does this mean for Real Estate?

Loans at below market or nil interest rate are not advanced at fair value. Practically, this means that the cash advanced will not be the receivable recorded. Instead, the receivable will be recorded at a lower amount, to take into account the impact of discounting at a market interest rate.

A day 1 difference arises between the cash advanced and the recorded receivable. If the loan is advanced from a parent entity to its subsidiary, this difference is added to the cost of investment in the subsidiary because it is the nature of the relationship that gives rise to the off-market/interest-free loan. For loans to joint ventures and associates, this difference would also generally be added to the cost of investment as the relationship between the investor and the joint venture or associate is often the reason for the loan being off-market/interest-free.

Hedging

'Hedging' is a risk management activity. More specifically, it is the process of using a financial instrument (usually a derivative) to mitigate all or some of the risk of a hedged item. 'Hedge accounting' changes the timing of recognition of gains and losses on either the hedged item or the hedging instrument so that both are recognised in profit or loss in the same accounting period in order to record the economic substance of the combination of the hedged item and hedging instrument.



For a transaction to qualify for hedge accounting IFRS 9 includes the following requirements:

- An entity should formally designate and document the hedging relationship at the inception of the hedge. IFRS 9 requires additional documentation to show sources of ineffectiveness and how the hedge ratio is determined.
- There must be an economic relationship between the hedging instrument and the hedged item.
- Credit risk should not dominate value changes.
- The hedge ratio should be aligned with the economic hedging strategy (risk management strategy) of the entity.



What does this mean for Real Estate?

Real Estate entities mostly hedge interest rate risks and, where relevant, foreign exchange currency risks, by entering into interest rate and foreign currency swaps, forwards and options.

Entities will need to update their hedging documentation and ensure that a qualitative assessment of effectiveness for each hedging relationship is performed.

There is no longer an 80-125% effectiveness ‘bright line’ effectiveness test. As such a retrospective effectiveness test is no longer required to prove that the effectiveness was between 80 and 125%. However, all ineffectiveness should still be recorded in the income statement.

IFRS 9 gives companies a free choice over whether to adopt its new hedge accounting requirements when the remainder of IFRS 9 becomes mandatory in 2018. A company must either move all of its hedge accounting to IFRS 9, or it must continue to apply IAS 39 to all of its hedges.

However, all entities have to apply IFRS 9’s new disclosure requirements – including the new disclosures around hedge accounting.

Financial liabilities

Debt modifications

Real estate entities might restructure borrowings with banks to adjust interest rates and maturity profiles and hence modify their debt.

When a financial liability measured at amortised cost is modified without this resulting in derecognition, a difference arises between the original contractual cash flows and the modified cash flows discounted at the original effective interest rate (the 'gain/loss').

Entities were permitted, although not required, to recognise the gain/loss in the income statement at the date of modification of a financial liability under IAS 39. Many entities deferred the gain/loss under IAS 39 over the remaining term of the modified liability by recalculating the effective interest rate.

This will change on transition to IFRS 9 because the accounting will change. When an IFRS 9 financial liability, measured at amortised cost, is modified without this resulting in derecognition, the gain/loss should be recognised in profit or loss. Entities are no longer able to defer the gain/loss.

The changes in accounting for modifications of financial liabilities will impact all preparers, particularly entities which were applying different policies for recognising gains and losses under IAS 39.

Whilst entities were not required to change their IAS 39 accounting policy, the impact on transition to IFRS 9 should be considered. IFRS 9 is required to be applied retrospectively, so modification gains and losses arising from financial liabilities that are still recognised at the date of initial application (for example, 1 January 2018 for calendar year end companies) would need to be recalculated and adjusted through opening retained earnings on transition. This will affect the effective interest rate and, therefore, the finance cost for the remaining life of the liability.

Questions

PwC clients who have questions about this in depth should get in touch with their regular PwC contact.

Ansprechpartner in Ihrer Nähe



Raoul Vogel
Tel: +43 1 501 88-2031
raoul.vogel@pwc.com



Bettina Szaurer
Tel: +43 1 501 88-1833
bettina.szaurer@pwc.com

Medieninhaber und Herausgeber: PwC Österreich GmbH Wirtschaftsprüfungsgesellschaft, Donau City Straße 7, 1220 Wien
Für den Inhalt verantwortlich: Raoul Vogel
Kontakt: IFRS.Aktuell@at.pwc.com

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