

Increasing transparency and comparability: the way forward*

IFRS Real Estate Survey – Details of 2006 Results

IFRS – Global Reporting Revolution • November 2007



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IFRS – where we stand now

The global shift to International Financial Reporting Standards (IFRS) is changing fundamentally the way real estate firms present their business and the way their financial statements are judged by analysts, investors and others. More information is finding its way into the opening sections of annual reports: for example, the wider inclusion there of industry ratios such as triple net asset value (NNNAV). But just how well is the industry absorbing these changes into its financial reporting and turning them to advantage?

PricewaterhouseCoopers¹ detailed analysis of the financial statements of 50 real estate firms reveals how they are applying these standards and what choices they are making within them. The findings of this survey are described in this report. This report gives a broad picture of the impact of IFRS on the transparency, consistency and comparability of companies' disclosures and uncovers marked variations in interpretation and practice.

This report is designed to help firms to assess the transparency of their financial statements and to interpret and understand the methods and options adopted in IFRS financial statements. Above all, the survey's findings point out how important it is for members of the industry to work together to enhance the clarity, consistency and relevance of their financial statements, especially in areas where the IFRS regime offers some freedom to choose the basis of measurement or the format of presentation.

A summary of the findings is available in a separate document (referred to as the Summary of 2006 results).

IFRS – the way forward

It is clear from this survey that real estate firms have some way to go to increase the transparency and comparability of their financial statements. The choices available in IFRS can lead to the adoption of different options, making comparisons difficult. Nevertheless, this has been an important year for financial reporting in the real estate industry. Continued cooperation and communication within the industry should lead to the greater transparency that will in turn produce increased comparability – to the benefit of all stakeholders in the business.

¹ 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Executive Summary

Key findings

We identify differences in application of IFRS and map the diversity of industry practice through a desktop review of the presentation and disclosure of financial statements. We also identify the key findings associated with the topics noted below.

How real estate firms are applying IFRS guidance to their financial statements.

Topic	Key Finding*
Recognition, measurement and classification	Besides investment property, which shows up in nearly all financial statements, the categories used in the balance sheets are PPE own use, PPE development, inventory, transaction property and assets held for sale. But not all these categories of real estate assets are defined and described properly in the accounting policies.
Income statement	<p>Various components are presented as part of revenue. In some cases, not only various components of revenue but also costs are included as part of revenue, leading to a net presentation.</p> <p>The notes and the accounting policies should clearly state what is included in revenue. Where service charges are included in revenue on a gross basis, it is unclear that the entity acts as principal rather than as an agent.</p>
Acquisitions	The implications of the distinct accounting treatment of asset deals and of business combinations are missing, especially in relation to deferred taxes and to goodwill.
Development property	<p>Where an entity has development property, this is presented separately in the balance sheet or in the notes and, in rare circumstances, as construction contracts. Development property is measured at cost.</p> <p>The criteria of real estate transfer in and out of investment property are not disclosed in the accounting policies.</p>
Deferred tax	The deferred tax balance is not well disclosed. How this balance has been calculated, what the impact is of adjustments on this balance, the impact of different tax rates or of tax-efficient structures, is not clear.
Lease incentives	Generally, the impact of lease incentives on the valuation of real estate assets is not disclosed.

*Note: there were no key findings for operating and finance leases, cash flow statement, and IFRS 7.

Findings – commentary by topic

Findings are based on the answers to a list of carefully designed questions on these topics, completed by our project research team.

- **Recognition, measurement and classification**

The notes to the financial statements provide useful qualitative disclosures to help users understand the business, but not all categories of real estate assets disclosed in the balance sheet are defined and described in the accounting policies. The accounting treatment upon initial and subsequent measurement for each category is, therefore, unclear, as is the treatment of recognition and derecognition. Real estate entities are diversifying their activities in order to achieve the performance levels their stakeholders expect; transparency in reporting new activities is key to the user of financial statements.

- **Income statement**

There is a variety of terms used in the definitions of revenue noted in the survey, and hence substantial divergence of practice. Comparability of the income statement is vital to the users' proper analysis of the results of real estate firms and individual real estate assets. Further, disclosure of whether the entity acted as a principal or as an agent is missing – information that may clarify the accounting treatments applied in the income statement.

- **Acquisitions**

It is clear that many investments are occurring each year and these activities are well described in the opening sections of the annual report (that is, not in the financial statements). Differences in defining and describing the accounting treatment of an asset deal compared with a business combination, and the implications on the recording of goodwill in the balance sheet, are disclosed in their accounting policies by only a few businesses. Further, the assessment of the goodwill (including deferred tax balances) and the use of the initial recognition exemption are not applied consistently.

- **Development property**

The criteria of real estate transfers in and out of development property are not disclosed in the accounting policies. It is difficult to assess valuation changes recorded upon transfers out of the development property category, as these disclosures are limited.

- **Deferred tax**

Potentially significant considerations to deferred tax in the real estate industry, such as using the applicable tax rates for settlement (use of corporate tax, capital gains tax and other applicable tax rates, on an asset-by-asset basis, to assess the applicable effective tax rate) is well understood within the industry, but not well disclosed. The disclosure of tax-efficient structures, such as the wrapper or the Real Estate Investment Trust (REIT), or reinvestment facilities, is made only by a few entities.

- **Lease incentives**

The potential impact of lease incentives on the valuation of real estate assets is generally not mentioned. The correct treatment of lease incentives is well known in the real estate industry. The survey results provide no evidence of double counting of lease incentives, but the lack of disclosure in this area may lead to some doubt (in the eyes of the uninformed user) about whether or not real estate asset valuations are in fact adjusted to take into account the impact of lease incentives.

- **Operating and finance leases**

The distinction between operating leases and finance leases is disclosed in the accounting policies. The disclosures in the financial statements on leasing do not connect with the pattern of revenue recognition on an asset-by-asset basis.

- **Cash flow statement**

The cash flow statements guidance in IFRS was applied consistently by the firms surveyed. Very limited disclosures regarding the difference between firms' operating and investing activities are included in the financial statements.

- **IFRS 7**

None of the subjects surveyed chose early adoption of IFRS 7 in their financial statements.

About this survey

We identify differences in application of IFRS and map the diversity of industry practice through a desktop review of the presentation and disclosure of financial statements.

The 50 IFRS financial statements on which the survey is based fulfil the following criteria:

- A significant part of the firm's business is in real estate.
- Reporting has been made under IFRS in the 2006 financial statements and is available in English.
- The financial statements have been audited.

All the financial statements analysed are posted on publicly available internet websites. No preference is given to any particular country, entity size or complexity of operations, and the annual reports are randomly selected to find a representative sample.

The main focus is on Europe, and financial statements from this region form the bulk of our sample. We also include a report from Hong Kong and a report from Australia to expand the 2006 survey into the Asia Pacific region.

Of the 50 financial statements, 45 are from listed companies and five from non-listed. See appendix 1 for the list of the surveyed financial statements.

We examine the following topics for the reasons set out:

Topic	Reason for examination
Recognition, measurement and classification	because the categories presented in the balance sheet have to be defined and described in the accounting policies relating to these categories. The questions are designed to reveal how well the relevant aspects of recognition and measurement are disclosed in the accounting policies.
Income statement	questions focus on the comparability of income statements under IFRS and how clear it is in the accounting policies whether the gross or net basis of presentation is used for revenue and whether or not any disclosures are made in the financial statements on acting as a principal or an agent.
Acquisitions	is selected as a topic to find out whether or not real estate firms are making a clear distinction in their accounting policies between a business combination and an asset deal. IFRS guidance on business combinations is extensive, but guidance available on asset deals is less comprehensive.
Development properties	selected in response to the marked trend for investment property firms to diversify their operations into development activities in order to achieve higher returns on real estate assets. Questions focus particularly on the disclosure of the transfers out of development property.
Deferred tax	is the subject of intense debate, but interpretations of IFRS are generally not well disclosed. The survey clarifies some guidance applicable to real estate firms and records how that guidance is being applied in practice.
Lease incentives	because it is important to understand the extent of disclosure of lease incentives within the financial statements. The industry understands well the relevant accounting for recognition and measurement of lease incentives, but the disclosure aspects are the focus of questions on this topic.
Operating and finance leases	to assess whether real estate firms make it clear in their accounting policies that the leases are generating revenues for the real estate assets. The disclosure of the implications of finance leases in real estate assets is also assessed.
Cash flow statement	to determine whether real estate firms classify their real estate activities (particularly the purchase and sale of real estate assets) as operating or investing activities and whether or not the accounting policies help users to understand their selections.
IFRS 7	to assess whether or not real estate firms have considered early adoption of the standard and whether or not the disclosures made improve understanding of the financing activities of the real estate firm.

1. Recognition, measurement and classification

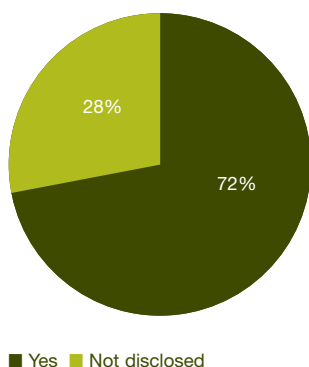
How are real estate assets classified in the balance sheet?

Real estate assets are in most cases included in investment property which was disclosed on the face of the balance sheet for nearly all the financial statements in the survey. Refer to the graph below for the categories of real estate which were distinguished in the balance sheets of the financial statements surveyed.



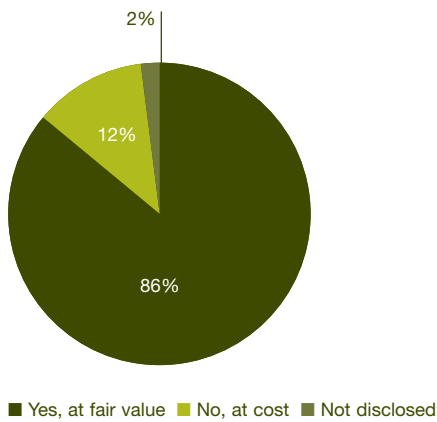
The findings indicate that investment property is the most used category of real estate asset on the balance sheet, however there are also several other categories of real estate disclosed (one surveyed financial statement did not list investment property on its balance sheet, as it recognised inventory instead). Diversity of business activities of real estate entities over the past years has led to an extension in the number of categories required in the balance sheet to adequately describe their real estate assets and their activities. The challenge for the real estate entities is to appropriately define and describe these categories of real estate and their accounting implications for the results of the business.

Are investment properties initially valued at cost?



How are real estate asset categories accounted for, and does the accounting policy reflect these treatments?

The diversity of real estate activities has made the methods of accounting applied to the real estate assets in the financial statements more complex, as the mixture of disclosures for the different categories of real estate has reduced the clarity of the disclosures made. This increase in number of activities has a multiplying effect of increasing the number of accounting policies and the number of notes to the financial statements required. If only investment property is on the balance sheet, then potentially only one basis of measurement is relevant (initial measurement at cost and subsequent measurement at cost or fair value).

Are investment properties subsequently measured at fair value?

	Initial measurement (number of entities)	Subsequent measurement (number of entities)
At cost (less depreciation)	36 (72%)	6 (12%)
At fair value	-	43 (86%)
Not disclosed	14 (28%)	1 (2%)
Total	50 (100%)	50 (100%)

In the results in the above table most entities disclosed that investment property is initially measured at cost and subsequent measurement is at fair value. There were also entities that did not disclose the initial measurement basis at all. For one set of financial statements, investment property was not listed on the face of the balance sheet, so no accounting policy was disclosed for investment property.

Property, plant and equipment ('PPE') for own use

Furthermore, we noted that in 37 out of 50 entities (74%), PPE own use was disclosed separately from investment property and other property, plant and equipment (such as office equipment). This indicates that when the asset is utilised for the operational activities of the real estate entity itself (such as office buildings to house the operations and staff) a distinction is made between accounting treatments. For real estate assets (PPE) for own use (purposes), and real estate assets for investment purposes, the measurement basis generally differs. Real estate assets (PPE) for own use are usually valued at cost while assets held for investment purposes have been valued at cost or at fair value.

Inventory, trading property and assets held for sale

The category of inventory was disclosed on 17 out of 50 (34%) financial statements.

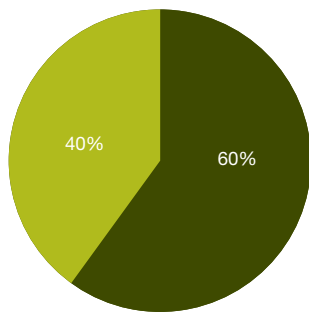
When we looked into the treatment of assets held for sale, inventory and trading property (that is real estate assets intended for sale that do not meet the assets held for sale criteria) we noted that 24 out of 50 (48%) financial statements disclosed trading property or assets held for sale on their balance sheet. Measurement of these assets is shown in the table below.

	Subsequent measurement (number of entities)
Lower of cost (less depreciation and less impairment) and net realisable value	14 (58%)
At fair value	10 (42%)
Total	24 (100%)

Construction contracts

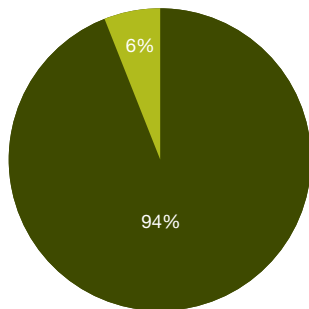
The findings related to construction contracts and development property are detailed in section 4 of this report.

Do the accounting policies define the different categories of real estate in the balance sheet?



■ Yes ■ No

Do the accounting policies reflect the different accounting treatments of real estate categories?



■ Yes ■ No

Accounting policies per category

The accounting policies disclosure distinguished between the categories disclosed in the balance sheet by providing definitions for the relevant categories of property in 30 out of 50 (60%) reports surveyed (most commonly defined was the difference between investment property and property, plant and equipment own use). The remaining 20 out of 50 (40%) did not mention the definition of investment property compared with other categories of real estate presented on the balance sheet.

The accounting treatment for investment property and other categories of property (such as development property, property plant and equipment own use, inventory and assets held for sale) we found not disclosed in three out of 50 (6%) cases but a statement of compliance with IFRS guidance was disclosed in its place. Other disclosures in the notes to the financial statements assisted in understanding of the financial statements, but it is expected that this understanding stems from the accounting policies.

The definition and accounting treatment of the other categories of real estate may also have been useful, as applicable, to include in the accounting policies. For those 20 out of 50 (40%) entities not disclosing other categories (except for investment property) in the accounting policies, more information in the accounting policies seemed necessary when comparing the activities of these real estate entities as disclosed in the front sections of their annual reports, with the contents of their balance sheets, and the notes to the financial statements (for example trading property or inventory seems applicable to most financial statements within the survey, but the results do not reflect this).

Generally the accounting policies did not disclose for all categories of real estate listed in the financial statements the definition and the accounting treatment applicable on recognition and subsequent measurement.

Included in accounting policies	Results (number of entities)
Definition of the criteria to be met to trigger transfers of assets between categories	22 (44%)
Recognition and measurement of the gains and losses made on transfer and derecognition of assets	31 (62%)
Derecognition criteria	12 (24%)
Transaction costs in recognition or derecognition	39 (78%)

IFRS sets criteria for transfer of assets from one category of real estate assets to another, so the accounting policies would reflect applicable definitions of the criteria to be met to trigger a transfer between categories and that the change in the accounting method would also be disclosed. Refer to appendix 2 for some guidance on inclusions for the accounting policies.

Likewise, there is specific guidance provided on derecognition of investment property in IFRS, and therefore some reference to derecognition in the accounting policies should be made. Other disclosures in the notes to the financial statements assisted in understanding of the transfers and derecognition between categories; however, the most appropriate place for this information is also in the accounting policies.

Given the significance of transaction costs in real estate acquisitions (and sales), an accounting policy on transaction costs may clarify the proper treatment applied in accordance with IFRS 3 and IAS 40 when purchasing and selling real estate assets.

What is the impact on financial reporting if an investment property becomes an asset held for sale, or if a development property becomes an investment property?

When investment property becomes property with an intention to sell, or when property plant and equipment for own use becomes investment property, the accounting policy may also change, in which case a quantitative disclosure of the determination of the carrying value, at date of transfer, may be useful information for users to assess the results of that transfer.

When development property is transferred to investment property, the basis of measurement often changes from cost to fair value (based on our survey results). A reconciliation of the carrying value at date of technical completion of the development property, fair value at date of transfer into investment property, and disclosure of how the gain or loss in value was recognised would clarify the change in basis of measurement and proper accounting treatment of these assets.

An investment property held for sale as defined by IFRS 5 should be presented as an asset held for sale: it should be removed from the investment property in the balance sheet. The notes to the financial statements should provide a quantitative explanation of such recategorisations from investment property to assets held for sale.

For guidance on the accounting policies on investment property and other categories of real estate assets under IFRS, refer to appendix 2.

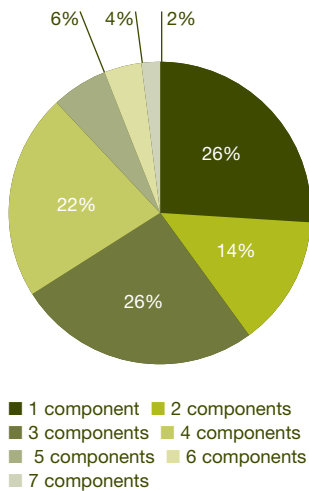
Conclusion on recognition, measurement and classification

The notes to the financial statements provided useful qualitative disclosures to assist the users with understanding the business; however, we would have expected that more of this information was included in the accounting policies. Not all categories of real estate available in the balance sheet were defined and disclosed in the accounting policies. Therefore the accounting treatment upon initial and subsequent measurement was unclear and also the treatment of recognition and derecognition was not clear.

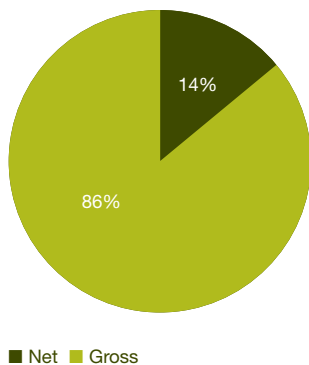
For a user of the financial statements, it would also be beneficial to know if an asset from development property has been transferred into another category, such as an asset held for sale or investment property, as this may signal a change in the basis of measurement for the asset. Disclosing this information assists the user in assessing the profitability and benefits to the business of undergoing such activities, and better highlights the impacts of such changes in investment strategy. Further, IAS 40 disclosure requirements, as set out in paragraphs 74-79 require that any changes in the categorisation of investment property during the period should be disclosed.

2. Income statement

How many components of revenue are included in the income statement?



How is revenue disclosed in the income statement?



What is included in revenue in the income statement?

In the survey we found various definitions of revenue. This diagram shows the variety of the results. Most entities presented revenue on a gross basis, but which components were included in the gross revenue varied significantly. Also, when revenue was disclosed on a net basis, we noted several variations of the components that comprised net revenue.

Revenue is defined as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity. Under IFRS it is possible to present revenue on a gross or net basis, depending on the activities performed.

The diagram opposite shows that in 43 out of 50 (86%) financial statements revenue is presented on a gross basis and in 7 out of 50 (14%) financial statements revenue is shown on a net basis. Gross is defined as showing both income and operational costs on the face of the income statement and net is defined as net revenue (being revenue minus costs) mentioned on the face of the income statement

Further IFRS guidance on revenue is available in appendix 3.

How to account for revenue and does the accounting policy reflect this treatment?

We found the following components included in revenue:

Rental income

Similar income (parking fees, key money, occupancy compensation);

Changes in fair value

Revenue from project development

Revenue from contracts

Revenues guaranteed by developers

Guaranteed rent increases

Surrender premiums

(Development) Property sale

Management fees

Interest income

Cost of rent-free periods

Concessions granted to tenants (incentives)

Indemnities for early termination of rental contract

Compensation for financial leasing and comparable items

Allowance for doubtful debtors

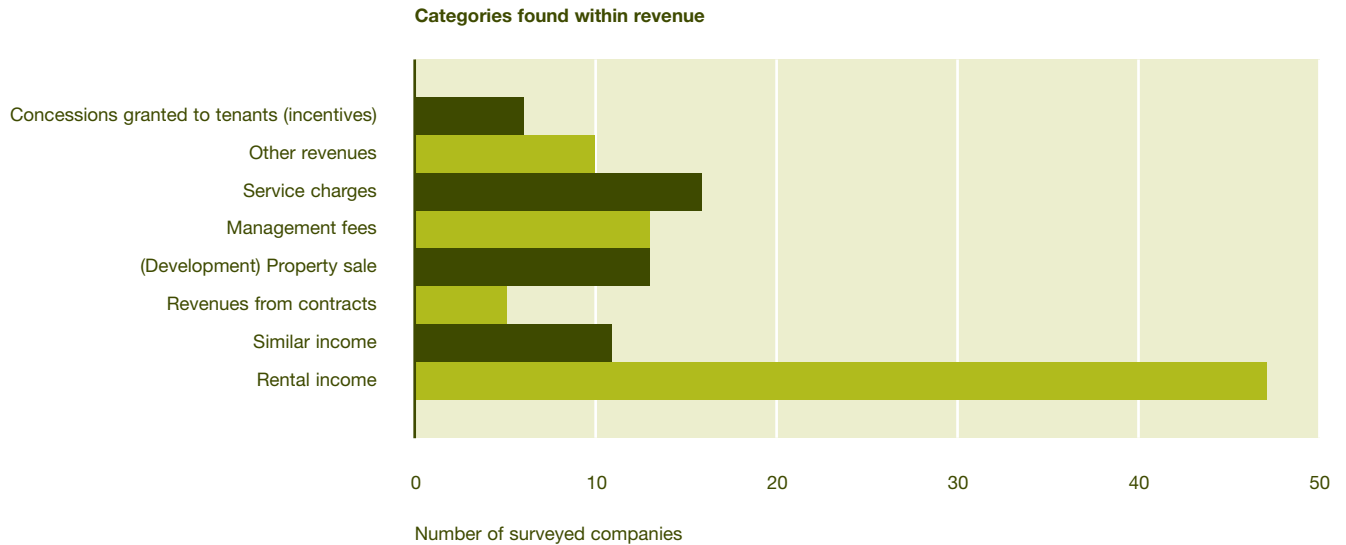
Allowance for tax amortisation

Change in unrealised reserve

Service charges

Other revenue

Operating costs that produce rental income



If items are being deducted from the revenue, the users of financial information should be informed.

Lease incentives

From the disclosures in financial statements of the entities surveyed it was not always clear how these costs (lease incentives) were accounted for. Refer to section 6 of this report where lease incentives are discussed in further detail.

Service costs and service charges

Service costs are presented on a gross basis or on a net basis depending on whether the entity is acting as an agent or as a principal. On a net basis, service charge costs are offset against service charge incomes and on a gross basis they are reported separately. Being an agent, it is permitted to disclose service charges on a net basis. If acting as principal, service charges should be disclosed on a gross basis and the service charges income is recorded as a component of revenue.

Income statement and accounting policies	Results (number of entities)
Service charges on a gross basis	21 (42%)
Service charges on a net basis	29 (58%)
Total	50 (100%)
Agent or principal disclosure	7 (14%)

What is the impact of the broad definitions of revenue in the financial statements?

The variety of definitions of revenue makes comparability of the revenue of the entities difficult. Due to the fact that the revenue is defined as the gross inflow of economic benefits in the ordinary activities of the entity, it depends upon the activities of the entity to determine what components are included in revenue.

Conclusion

The diversity in the definitions of revenue we noted was substantial. The need for comparability in the income statement is key to the users and their proper analysis of the results of real estate entities. Further, the disclosures relating to whether the entity acted as a principal or an agent for each asset were missing. The disclosure of this may have clarified the accounting treatments applied in the income statement.

3. Acquisitions

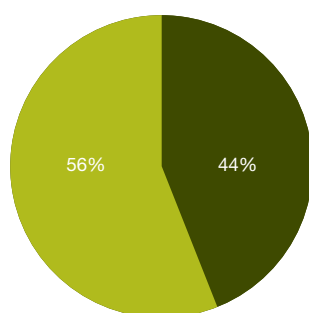
Where are acquisitions classified in the balance sheet?

In a total of 42 out of 50 (84%) financial statements acquisitions were disclosed and in eight cases no acquisitions were mentioned.

	Results (number of entities)
Goodwill disclosed in the balance sheet	22 (44%)
No goodwill disclosed in the balance sheet	20 (40%)
No acquisitions disclosed	8 (16%)
Total	50 (100%)

The above implies that asset deals had indeed been closed, or the goodwill relating to the transactions during the year was fully impaired at reporting date, but this was difficult to conclude based on the level of disclosures made.

Do the surveyed companies disclose goodwill?



■ Yes ■ No

In total 22 of the 50 surveyed entities (44%) included goodwill in their balance sheet.

Disclosures relating to goodwill in 13 out of the 22 (65%) instances did not include a basis of recognition or a description of an approach towards impairment within their disclosures.

In case of no control, an acquisition cannot be treated as a business combination.

How are business combinations versus asset deals accounted for, and do the accounting policies reflect this treatment?

Most financial statements described the process for recognising a business combination. In only 15 out of 50 (30%) financial statements the accounting policies for acquisitions detailed the definition and treatment of a business combination as opposed to an asset deal. We noted what appeared to be asset deals in 37 out of 50 (72%) financial statements, but without specific disclosures this was difficult to conclude.

The main distinction between a business combination and an asset deal is the recording of goodwill on the balance sheet. In the case where the acquisition is treated as an asset deal, no goodwill will arise. Further, the initial recognition exemption for deferred taxes applies for asset deals.

If an acquisition is recorded what accounting impact should be considered?

In case of a business combination, the deferred tax recognised in the corporate wrapper that was acquired should be based on the temporary differences between the fair value at the moment of acquisition and its cost basis. The deferred tax liability should be recorded on the balance sheet, and then this balance will lead to goodwill tested for impairment each reporting period.

In case of an asset deal, IFRS 3 is not applicable and therefore no goodwill will be recognised in the consolidated financial statements due to the acquisition. For these acquisitions, the initial recognition exemption applies, which means that the cost basis of the underlying asset will be the fair value at the date of acquisition.

A consideration when entering into share deals is also how to deal with the deferred tax balances acquired. Do these indeed have the characteristics of goodwill? If so, the impact is changing the accounting treatment of the asset deal, to be more like the accounting treatment for a business combination. Or should the deferred tax acquired in asset deals, to the extent that it will never be settled, be written off via the P&L upon acquisition? The guidance in IFRS 3 and IAS 12 overlaps in this area and may lead to confusion. We observed in the survey results that the accounting policies did not depart from standard disclosures in this area, with very few survey participants detailing their deferred tax treatments relating to acquisitions.

Conclusion

From the survey, it is clear that many investments are occurring each year, and these activities are well described in the front sections of the annual report (that is, not in the financial statements). The difference in definition and accounting treatment of an asset deal compared with a business combination, and the implications on the recording of goodwill in the balance sheet, were only disclosed by a few entities in their accounting policies.

One significant aspect of acquisitions, as highlighted by the survey responses, was how the deferred tax balances are dealt with. IFRS 3 provides guidance that any deferred tax acquired, to the extent that it would never be settled in case the sale will take place in shares, should also be recognised as goodwill. The assessment of the deferred tax balances and use of the initial recognition exemption is not consistently applied within the accounting policies. Other disclosures made in the notes to the financial statements attempted to clarify this treatment.

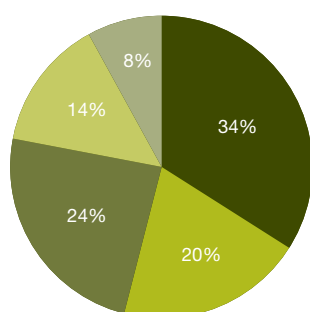
4. Development property

How is development property classified in the balance sheet?

IFRS allows the classification of development projects under property, plant and equipment or inventory, or construction contracts in the case that the definition of a construction contract is met.

Of the 50 entities in the survey 36 included development activities as part of their business. Of the 36 (72%) financial statements that we surveyed that included development properties, we found the following.

How are development activities classified on the balance sheet?



- As 'development projects'
- As 'other property, plant and equipment'
- n/a
- Under fixed assets as 'pipeline'
- As 'construction contracts'

There was a variety in the definition of a development property in the accounting policies of the developers.

Defining development property in relation to construction contracts was rare in the investment property entities; we found this definition in five cases out of 36. The percentage of completion method is used to recognise this type of development property in line with IAS 11, but those assets where percentage of completion is applied are not separately disclosed from other development property. Percentage of completion was not applied to the entire development property category.

How is development property accounted for, and do the accounting policies reflect this treatment?

In the table below the results show the most used basis of valuation is at cost, followed by lower of cost or market value.

	Basis of valuation (number of entities)
At cost value (less depreciation less impairment)	24 (66%)
Lower of cost or market value	11 (31%)
Basis of valuation not disclosed	1 (3%)
Total	36 (100%)

These financial statements did not define the criteria for selecting the percentage of completion method for the accounting treatment compared with the other methods usually adopted for accounting for development property (using cost as a basis), except to disclose that the contract terms must be reliable and measurable.

If a development project is completed what accounting impact should be considered?

The financial statements surveyed included 11 out of 36 (31%) that did not disclose the accounting treatment used to transfer the development property, upon completion, into a new category of property. Some appeared to transfer development property directly into assets held for sale. Others transferred the development property directly into investment property, and the transfer of development property into inventory was also applied. This shows the difficulty of comparing development projects for the users of financial information, as there appears to be a lack of

consistency between the basis of measurement of the development property itself. In addition to this, the basis of measurement after the transfer and the treatment of gains or losses arising from such a change varied.

Development property transfers take place at technical completion date using the following basis	Basis of valuation (number of entities)
At fair value	25 (69%)
At cost (less depreciation less impairment)	1 (3%)
At net income	1 (3%)
Not disclosed	9 (25%)
Total	36 (100%)

The above were transfers either to investment property (measured at cost less depreciation less impairment, or at net income, or at fair value) or inventory, or assets held for sale.

Conclusion

The criteria of real estate transfers between development property and other categories were not disclosed in the accounting policies, but in some instances were in the notes to the financial statements. Changes in the basis of measurement of development property upon technical completion and transfer into inventory, assets held for sale, investment property or PPE own use were not well disclosed in the accounting policies. The results of such development activities are difficult to assess.

The presentation of development properties as investment properties was a common finding. Usually (in 43 out of 50 financial statements surveyed) the investment property is measured using fair value as a basis and the development property is measured using cost as a basis.

If development property is included within the investment property for the first time, given that the basis of measurement is changed from cost to fair value, it would be useful to include a reconciliation of the carrying value at the date of completion and the opening fair value. Likewise, other movements between real estate categories should be disclosed in line with the IAS 40 disclosure guidance.

5. Deferred taxes

Has deferred tax been classified in the balance sheet?

Most of the surveyed reports (44 out of 50 or 88%) disclosed that deferred tax was a component of their balance sheet. The deferred tax was classified as current or non-current, using the timing of expected reversal of the deferred tax balance as the basis for its classification. The overall findings suggest that although the deferred taxes were disclosed, the disclosures were limited in the context of understanding the impact of deferred taxes on the results of the real estate acquisitions and sales.

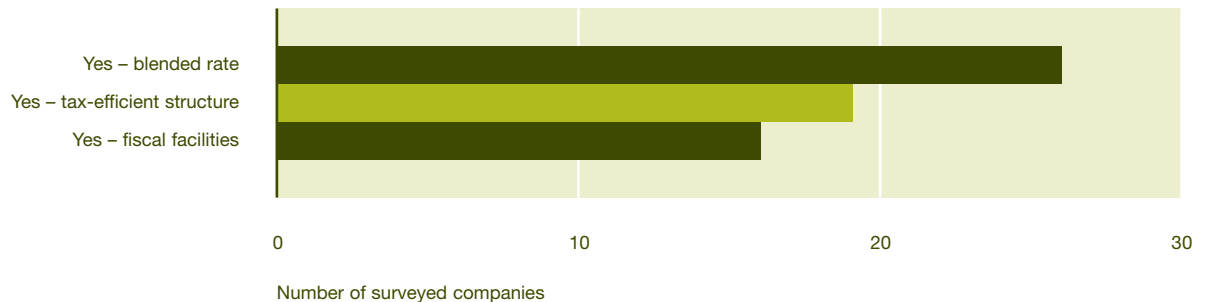
How is deferred tax accounted for, and do the accounting policies reflect this treatment?

Basis of valuation	Results (number of entities)
Deferred taxes recognised on nominal basis	30 (60%)
Deferred taxes recognised on discounted basis	1 (2%)
Not disclosed how deferred taxes are recognised	19 (38%)
Total	50 (100%)

In the table above deferred taxes are recognised most of the time on a nominal basis. For 19 entities it was not possible to assess due to the fact that they did not disclose the basis of valuation of deferred taxes.

Our results do not show that the method of recovery and settlement is relevant to the recording of deferred tax balances, as only 26 out of 50 (52%) financial statements disclosed the fact that different tax rates were used to calculate the deferred tax based on expected recovery and settlement (the blended rate approach). A total of 19 out of 50 (38%) financial statements disclosed that they considered the impact of tax-efficient structures acquired in calculating the deferred tax balances (e.g. considered that the deferred tax balances would never be settled or recovered, in case the corporate wrapper is sold instead of the property itself). Further, we noted another (different) 16 out of 50 (32%) financial statements which considered the impacts of fiscal facilities such as reinvestment in their calculation of deferred tax.

Only five out of 50 (10%) financial statements mentioned the consideration of all three significant deferred tax considerations and included a disclosure on different tax rates, tax-efficient structures and applicable fiscal facilities in the calculation of their deferred tax balances. From our results, we could see 19 out of 50 (38%) financial statements that considered at least one of the above components in their accounting policies (as opposed to other disclosures in the notes to the financial statements).

Do real estate entities disclose each aspect considered in calculating the deferred tax?

Blended rate refers to different tax rates applied for recovery and settlement of deferred tax balances depending on the recovery of the carrying amount of the asset: through use, through sale or through use and sale.

When a deferred tax is recorded, what accounting impact should be considered?

In some countries the tax legislation for investment properties may be quite different from the normal taxation regime for other activities. Different amounts of tax, if any, may arise dependent on the way transactions are legally structured. It is commonplace in the investment property industry to structure property acquisitions and disposals in a tax-efficient manner. In practice this often involves the transfer of a legal shell or entity (the ‘wrapper’) that holds the property. This may even be the case for other reasons, for example avoiding the registration of changes in ownership in public records such as land register or avoiding the need to renegotiate lease contracts. The wrapper owning the property thus creates flexibility for its owner to structure the sale by means of an asset or a share deal, as the most beneficial at a given point in time. Refer to the acquisitions section for some further discussion on this item.

In IAS 12 guidance is given regarding deferred taxes. See appendix 5 for more on this topic.

Conclusion

Potentially significant considerations to deferred tax in the real estate industry, such as applying the applicable tax rates for settlement (use of corporate tax, capital gains tax and other applicable tax rates, on an asset by asset basis, to assess the applicable effective tax rate), the availability of tax-efficient structures such as the wrapper or the REIT, or reinvestment facilities, were only disclosed by a few entities.

Inconsistency between the standards may lead to confusion here. Carry forward of deferred tax in a case where the deferred tax will not be recovered or settled seems illogical.

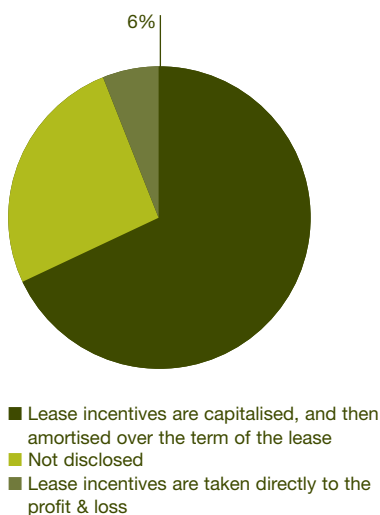
In some countries entities can have the status of a REIT or similar. This exempts both the rental income and the capital gains on disposal of the investment property from corporate income tax. In such cases, the tax rate to be used would be that applicable to a REIT (normally zero) and deferred tax needs to be recognised based on the rate applicable for the REIT. Special attention is required for the accounting of the deferred tax and the conversion payment required on the conversion of an entity into a REIT.

6. Lease incentives

Are lease incentives presented in the balance sheet?

In the financial statements surveyed, qualitative disclosures were made in relation to lease incentives and generally no quantitative disclosures. The majority of financial statements surveyed disclosed that lease incentives were granted to lessees (37 out of 50 or 74%). In 13 financial statements (26%) lease incentives were not mentioned. It is unusual that no lease incentives would have been granted for any lease in the portfolio of assets.

Do the real estate entities disclose the accounting policy for lease incentives?



How are the lease incentives accounted for, and do the accounting policies reflect this treatment?

The lease incentives appeared to be recognised in accordance with IFRS straight-lined over the term of the lease, as a reduction of rental income in 34 out of 50 (68%) financial statements, while three (6%) disclosed that lease incentives were taken directly to the profit and loss account and, as mentioned above, 13 (26%) did not mention lease incentives.

The description and definition available of the types of items that would be included in lease incentives was missing in the majority of instances, and disclosure of letting fees, and other lease negotiation related items, was also lacking (less than 25% included such disclosures). Lease incentives are a central part of lease negotiations.

If a lease incentive is recorded, what accounting impact should be considered?

If a lease incentive is recorded and the cost model is adopted, the lease incentive should reduce the rental income revenue straight-line over the term of the lease (unless an alternative basis is determined to be more representative of the flows of benefits from the lessor to the lessee). The impact on the value of the investment property of lease incentives is limited, as the basis of measurement is cost.

When a lease incentive is granted under the fair value model, then the above treatment applies with one important additional consideration. The fair value of the investment property should be adjusted to reflect the fair value of the lease incentives supporting the rental income cash flows. We only noted rare cases where a reconciliation of the fair value of the investment property to the face of the balance sheet separately identified the fair value impact of lease incentives.

For more information refer to appendix 6: IFRS guidance on lease incentives.

Conclusion

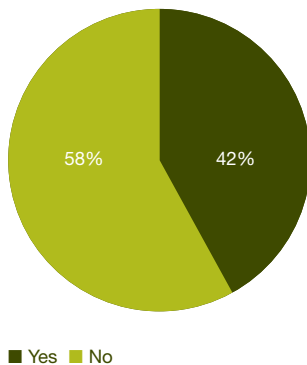
The potential impact of lease incentives on the valuation of real estate assets was generally not mentioned, which was unexpected given their importance in lease negotiations. To the uninformed reader, the valuation of assets may not have been adjusted for the lease incentives in place. This would result in double counting the fair value and prepaid or accrued operating lease income. As it is not well disclosed how valuations are adjusted to take into account lease incentives, this is a mistake that may easily be made.

Given the frequent use of lease incentives within the real estate industry, there were few disclosures available in the financial statement for users to understand these arrangements. The disclosure of lease incentives is required by IFRS. These amounts, which reduce the level of rental income and may impact the valuation of the asset itself, are useful for users of the financial statements to better understand and appreciate when evaluating the results of the leasing strategy and the strength of the cash flows supporting the asset value. Below is an example from the surveyed financial statements.

7. Operating and finance leases

How do we account for operating and finance leases and does the accounting policy reflect this treatment?

Do real estate entities disclose accounting policy for operating leases?



In the results 21 out of 50 (42%) financial statements disclosed the basis for valuation and the relevant accounting policy applicable for operating leases. This is unexpected when operating leases are the basis for rental revenue for real estate assets and the most common form of leases available in the real estate industry.

A total of 26 out of 50 (52%) financial statements disclosed the basis for valuation and the relevant accounting policies on finance leases. This is understandable when finance leases are less common in real estate leases. More specific disclosures including the length and economic value of the lease instalments which should be taken into consideration for the categorisation of a lease, were only available in seven out of 50 financial statements of the entities surveyed.

Refer to appendix 7 for more guidance on leases under IFRS.

Conclusion

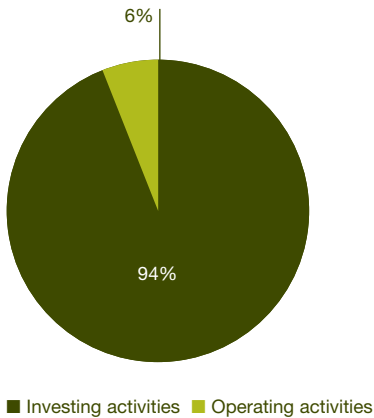
The definitions of operating leases and finance leases were disclosed in the accounting policies or further on in the notes to the financial statements. The disclosures made in the financial statements on leasing did not connect with the pattern of revenue recognition on an asset by asset basis.

The implications of operating leases versus finance leases to particular deal structures may be severe, so disclosures relating to leases are relevant to the users. In the real estate industry the link between leases and revenue recognition is important, and so the disclosure of lease definitions and classifications is useful for the users of financial information to determine leasing strategy results.

8. Cash flow statement

How are the sales and purchases of investment property and the relating development projects classified in the cash flow statement?

Do the surveyed entities disclose sales and purchases as investing activities?



In our results 47 out of 50 (94%) financial statements showed sales and purchases of real estate assets as investing activities and the remaining three showed them as operating activities. In total four out of the 50 (8%) did disclose the rationale of the principle revenue-producing activities.

Under IAS 7 operating activities are the principal (core) revenue-producing activities of the entity and other activities that are not investing or financing activities.

Investing activities are from the acquisition and disposal of long-term assets, and other investments not included in cash and cash equivalents. Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Without this disclosure, it was not possible to assess whether the classification of cash flows in the cash flow statement was appropriately made. There was no basis disclosed upon which to assess the classification as operating or investing or financing activities.

What accounting impact should be considered?

The question is whether the cash flow statements appeared to be consistent between the entities surveyed because they are indeed comparable, or whether they appeared comparable but should not have been.

It appears that the cash flow statements are consistent between the entities, but it is not possible for users of the financial information to assess whether the cash flow statements are truly comparable.

Conclusion

The cash flow statements guidance in IFRS was applied consistently in the entities surveyed. Sales and purchases of real estate assets and entities were part of the investing activities. Very limited disclosures regarding the difference between operating and investing activities for the real estate entities were included in the financial statements. In all financial statements surveyed the indirect method was used to prepare the cash flow statement, despite the standard setter's preference for the use of the direct method.

9. IFRS 7

The survey uncovered that none of the real estate entities had considered early adopting IFRS 7. Noted in the front sections of the annual report were some aspects of the disclosures expected to be made, but these disclosures were not made in the financial statements as required under IFRS 7.

Appendix 1: Financial statements surveyed

Listed Entities	
Aedes	Lamda Development
Affine	Land Securities
Babis Vovos	Leasinvest Real Estate
Befimmo	Nieuwe Steen Investments NV
British Land	Orco
Brixton	Pirelli RE
Cofinimmo	PSP Swiss Property
Corio	Quintain Estates and Development
Deutsche Wohnen	Renta Corporacion Real Estate
DIC Asset	Rodamco Europe
DIM Vastgoed NV	Spazio Investment
Eastern Property Holdings	Sponda
Eurocommercial Properties	TAG Property Group
Foncière des Régions	Unibail
Fortis Investment Management	Valad Property Group
Gecina	VastNed Offices
Groothandelsgebouw	VastNed Retail
Hammerson	Vivacon
Hongkong Land	Wereldhave
Immofinanz Immobilien Anlagen	Westfield Group
ING Real Estate	Workspace Group
IVG Immobilien	Züblin Immobilien Holding
Klépierre	
Non Listed Entities	
Beni Stabili Gestioni	Schiphol Real Estate
Eurocastle Investment Limited	Storebrand ASA
KFN Holding (listed debt only)	

Appendix 2: Guidance on accounting policies for investment property under IFRS

Initial and subsequent measurement

IFRS states that an investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement (IAS 40 para 20).

IFRS offers a choice for investment properties on subsequent measurement between accounting using the fair value model or cost model. Generally entities will select the fair value model as a basis to give more useful information on their performance.

After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value, except in the cases described in paragraph 53, when fair value is indeterminable (IAS 40 para 33). A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises (IAS 40 paragraph 35).

After initial recognition, an entity that chooses the cost model shall measure all of its investment property in accordance with IAS 16's requirements for that model, other than those that meet the criteria to be classified as held for sale.

Investment properties that meet the criteria to be classified as held for sale (or are included in a disposal group that is classified as held for sale) shall be measured in accordance with IFRS 5 (IAS 40 paragraph 56), in case these are subsequently measured at cost.

Transfers to or from investment property

Effective date of transfer

Transfers to, or from, investment property shall be made when, and only when, there is a change in use, evidenced by the criteria set out in the standard (IAS 40 paragraph 57). See also the table opposite with the different options under IFRS guidance.

Table: Transfers between categories of real estate

Initial status	Transfer	New status	Accounting Impact
Investment Property (IAS 40)	Redevelop existing investment property for continued future use as an investment property	Investment Property (IAS 40)	No impact
Investment Property (IAS 40)	To be developed with a view to (immediate) sale	Inventory (IAS 2) or Assets held for sale (IFRS 5)	Transfer to inventories made at fair value or to separate category 'Assets held for sale' (without re-measuring)
Investment Property (IAS 40)	To be used for the operating activities of the real estate entity	PPE own use (IAS 16)	Transfer to PPE own use made at fair value, and then this is deemed the cost, and is depreciated over the useful life of the asset
PPE Own use (IAS 16)	Own use completed with a view to hold and let as investment property (that is, no longer for own use)	Investment Property (IAS 40) (at fair value)	Any difference at that date between the carrying amount of the property and its fair value is treated the same way as a revaluation in accordance with IAS 16. This means that there will be a revaluation reserve within equity.
Inventory (IAS 2)	Development completed with view to sell	Inventory (IAS 2)	No impact
Inventory (IAS 2)	View to develop and sell changed to view to hold and let as investment property	Investment Property (IAS 40) (at fair value)	Difference between fair value of the property at date of transfer and its previous carrying amount shall be recognised in profit or loss
Development Property (IAS 16)	Development completed and let as investment property	Investment Property (IAS 40) (at fair value)	Difference between fair value of the property at date of transfer and previous carrying value recognised in profit or loss

Derecognition

Gains or losses arising from the retirement or disposal of investment property shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss (unless IAS 17 requires otherwise on a sale and leaseback) in the period of the retirement or disposal (IAS 40 paragraph 69).

When dealing with assets held for sale the measurement provisions of IFRS 5 do not apply to non-current assets that are accounted for in accordance with the fair value model in IAS 40.

An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups). (IFRS 5 paragraph 30).

Appendix 3: Guidance on revenue under IFRS

Revenue is defined as the gross inflow of economic benefits during the period, arising in the course of the ordinary activities of an entity, when those inflows result in increases in equity, other than increases relating to contributions from equity participations (IAS 18 paragraph 7).

The following has to be disclosed under IAS 18 paragraph 35a, as follows:

- a) The accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services,
- b) the amount of each significant category of revenue recognised during the period, including revenue arising from (i) the sale of goods, (ii) the rendering of services, (iii) interest, (iv) royalties, (v) dividends, and
- c) the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

Under IAS 1 paragraph 81 revenue should at least be included on the face of the income statement.

Under the annual improvements project of the IASB, the following is being discussed; should IAS 16 Property, Plant and Equipment be amended to require that the sale of assets that were previously held for rental be presented on a gross basis in the income statement in certain circumstances?

Appendix 4: Guidance on acquisitions under IFRS

In relation to business combinations, IFRS 3 provides that the acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 37 of IFRS 3 at their fair values at that date, except for non-current assets (or disposal groups) that are classified as held for sale in accordance with IFRS 5, which shall be recognised at fair value less costs to sell. Any difference between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities so recognised shall be accounted for in accordance with paragraphs 51-57, which deal with the accounting treatment of goodwill.

The acquirer shall recognise separately the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date only if they satisfy the criteria at that date and are probable and reliably measurable. In the case of an intangible asset (such as goodwill) the same criteria apply.

Appendix 5: Guidance on deferred taxes under IFRS

IAS 12 is based on the balance sheet liability method. It is based on the principle that a deferred tax liability or asset should be recognised if the carrying amount of an asset or a liability is higher (or lower) than its tax base, which is the amount attributed to the asset or liability for tax purposes. The measurement of the deferred tax asset or liability shall follow the expected manner of recovery or settlement, as expressed in the standard (IAS 12 paragraph 51). In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement (IAS 12 paragraph 52).

The recovery in the above paragraphs is of particular relevance to the measurement of deferred tax liabilities that arise on investment property. Generally, an entity expects to recover the carrying amount of an asset through use, through sale or through use and subsequent sale. Tax authorities may levy different rates of tax depending on whether the asset is recovered through use (income tax) or through sale (capital gains tax). Furthermore, certain assets may be revalued for tax purposes (increase due to indexation to eliminate the effects of inflation) only if the asset is sold. Therefore, the manner in which the entity expects, at the balance sheet date, to recover the asset directly affects the amount of tax that would be payable in future and should be reflected in the measurement of deferred tax at the balance sheet date. Refer also to the section on acquisitions for further discussion.

The deferred tax liability or asset that arises from the revaluation of a non-depreciable asset in accordance with IAS 16 paragraph 31 shall be measured on the basis of the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of that asset. Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate is applied in measuring the deferred tax liability or asset related to a non-depreciable asset (SIC 21 paragraph 5). Land, having an infinite life, is not depreciated and therefore no part of the asset's carrying amount is expected to be recovered (that is consumed) through use. It follows that the carrying amount of a non-depreciable asset can only be recovered through sale. This is confirmed by SIC 21 to also apply to land that is carried at revalued amounts under IAS 40.

Buildings are depreciable assets that are excluded from the scope of SIC-21, due to the fact that these are depreciable under IAS 16. Management's intention when measuring the deferred taxes should be assessed, and the intention should be clearly demonstrated and supported, in particular to support specific timing for a sale.

When the actual plans of the entity are to retain the property for a period of time and then sell it, the use of a blended rate best reflects management's intention. Even if the buildings are to be sold after a short period of rental, the carrying amount of the buildings should not be deemed to be recovered only through sale. This is consistent with IAS 12 paragraph 51. There seems to be no technical barrier to this approach being used.

When using a blended rate, there must be an apportionment of the carrying value; it should not therefore be assumed that the carrying amount will be fully recovered through sale. Deferred tax computation on investment properties should be made on an asset-by-asset basis.

There will be three possible methods for calculating the rate that should be used to determine the deferred tax related to the revaluation of the properties:

1. Use of sale rate (CGT). This is appropriate in the right circumstances – i.e. if a particular property is up for sale;
2. Use of income rate. This would be appropriate if no sales were envisaged;
3. Use of blended rate. This is the most realistic, as it reflects the actual plans of the entity relating to retaining or selling its properties.

Appendix 6: IFRS guidance on lease incentives

All incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net consideration agreed for the use of the leased asset, irrespective of the incentive's nature or form or the timing of payments (SIC 15 paragraph 3).

The lessor should recognise the aggregate cost of incentives as a reduction of rental income over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern over which the benefit of the leased asset is diminished (SIC 15 paragraph 4).

In determining the fair value of investment property, an entity does not double count assets or liabilities that are recognised as separate assets or liabilities (IAS 40 paragraph 50).

When a valuation obtained for investment property is adjusted significantly for the purpose of the financial statements (for example, to avoid double counting of assets or liabilities that are recognised as separate assets and liabilities as described in paragraph 50 mentioned above) the entity shall disclose a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements, showing separately the aggregate amount of any recognised lease incentives that have impacted the value, and other significant adjustments (IAS 40 paragraph 77).

IAS 17 provides guidance on accounting for operating and finance leases.

Appendix 7: Guidance on operating and finance lease under IFRS

Under IAS 17 a lease is classified as a finance lease if it transfers substantially all risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

For operating leases to meet the criteria of IAS 17 the lessor should disclose a) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods: not later than a year, later than one year and not later than five years, later than five years, b) total contingent rents recognised as income in the period, c) a general description of the lessor's leasing arrangements. For operating leases costs, including depreciation, incurred in earning the lease income are recognised as an expense.

Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised on a straight-line basis over the lease term even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished. Initial direct costs incurred by the lessor in negotiating and arranging an operating lease shall be added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

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