

INVESTMENT PROPERTY – THE COST-BASED MODEL OR THE FAIR VALUE MODEL. WHAT DO WE CHOOSE?

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Abstract: The current accounting rules governing investment property issues allow economic entities that own such assets to exercise their right of option through professional judgment for several models that allow for the subsequent evaluation of these balance sheet structures. Our study aims to analyze these valuation models and present the effects generated by the option for one or another of them. The analysis is carried out by referring to relevant opinions expressed in the specialized literature on this subject. The research results indicated that the option for one of the two models is not well defined, the factors that influence this option are diverse, and the advantages and disadvantages of applying one of the models can be interpreted differently depending on the objectives pursued by the entity.

JEL classification: M40, M41, M48

Key words: investment property; cost-based model; fair value-based model; IAS 40; option; impact.

1. INTRODUCTION

Non-current assets, such as real estate (buildings and land), tend to hold an increasing share in the asset structure of certain categories of economic entities, which is why the national and international accounting framework contains details regarding such elements.

In Romania, the concept of investment property was introduced into the accounting regulations with the appearance of OMFP no. 1802/2014 on individual annual financial statements and consolidated annual financial statements, the source of inspiration for the standard-setters being IAS 40 "Investment property". IAS 40 was adopted in 2001 and underwent significant revisions in 2003 and 2016.

In general, national accounting rules and IAS 40 make an exact demarcation between the concept of real estate property and investment property. While real estate properties are land or buildings intended to be used on an ongoing basis in the entity's business, investment property refers to land or buildings owned by the entity to be leased to third parties or to increase its value over time.

An important issue concerning this economic category concerns the valuation methods provided by the rules and used by economic entities. Given that the accounting rules offer the possibility of choosing between several accounting treatments for the subsequent valuation of investment property, the exercise of options in favor of one or

the other of the permitted models may have different effects. It may aim to achieve predetermined objectives by the economic entities.

To clarify these aspects, our study aims to answer two research questions:

RQ1: What are the investment property valuation models allowed to economic entities applying OMFP no. 1802/2014, respectively IAS 40, and what is the accounting treatment specific to each model?

RQ2: What are the financial implications of the option for each permitted model?

Further, the study is structured in the following sections: section 2 clarifies the objectives of the research, section 3 explains the research methodology used, section 4 analyzes the valuation models premised for investment property and presents the accounting treatment for each model, section 5 discusses the impact of the valuation models presented, and section 6 presents the most important conclusions of the research.

2. OBJECTIVES

The study aims to analyze the impact that the two models proposed by IAS 40 for the subsequent valuation of investment property can generate. To this end, we have two major objectives. First, we will present the accounting treatment involved in the valuation of investment property, both in the context of the referential based on OMFP no. 1802/2014 and in the context of IAS 40. Secondly, starting from the accounting treatment highlighted, we will analyze the impact generated by the option for each of the two models brought into discussion, and we will determine which model is recommended according to the strategic objectives pursued by the economic entities.

3. METHODOLOGY

To achieve the proposed objectives, we will use as a research methodology, on the one hand, the comparative analysis of national and international accounting standards, and on the other hand, the systematic analysis of the specialized literature. By reporting to the regulatory framework based on OMFP no. 1802/2014, respectively IAS 40, we will establish the main normative benchmarks that will allow us to present the specific accounting treatment of the two models that can be applied. At the same time, reporting to relevant points of view expressed in the specialized literature will allow us to identify the reference elements for presenting the impact that the option for one of the models can generate for an economic entity.

To identify the relevant specialized literature, the Web of Science database, the advanced search function, and the keywords "investment property", "IAS 40", "cost model" and "fair value model" were used, the search being carried out by topic (title, summary, and keywords). Only articles published in English from the Web of Science categories "economics", "management", "business finance" and "business" were considered.

4. ANALYSES

For the valuation of investment property, economic entities that recognize such assets in their financial statements may apply various valuation models.

These models are differentiated according to the regulatory framework to which we refer, as follows:

- economic entities that apply the accounting reference based on OMFP no. 1802/2014 may only apply the cost-based valuation model;

- economic entities that apply the IFRS-based reference can choose between the cost-based model and a fair value-based model.

In the case of economic entities that apply OMFP no. 1802/2014, investment properties are considered tangible fixed assets, and the recognition, valuation, and depreciation rules specific to this category of assets are applicable to them. Therefore, investment properties are valued at cost and are depreciated. For these economic entities, it should be noted that the use of the fair value model, within the meaning of IAS 40, is not permitted. For this category of entities, fair value valuation means, in fact, the revaluing of investment property at the end of the financial year, in compliance with the revaluation methods and rules specific to tangible fixed assets, in general. This means that the transition from the cost model to the fair value model can only be made at the end of the financial year. It should also be noted that, subsequently, the cost model can be returned to. In the case of these economic entities, in principle, fluctuations in fair values are recognized in equity through the revaluation reserve, and the profit and loss account is affected only in the following situations:

- expense - for a negative difference from revaluation, if a revaluation surplus has not previously been recorded on the account of the revaluation reserve;

- expense - for a negative difference from revaluation found after a revaluation surplus has previously been recorded, and the negative difference from revaluation exceeds the existing revaluation reserve;

- income - for a positive difference from revaluation found after a revaluation deficit has previously been recorded and charged to expenses.

In the case of economic entities that apply the accounting framework based on IFRS, and implicitly IAS 40, the option can be exercised between the amortized cost model and a fair value model. The cost model is based on the specific rules for tangible assets provided for in IAS 16, including the depreciation of assets. The fair value model, within the meaning of IAS 40, has several specific characteristics, as mentioned below: once chosen, the fair value model must be used for that asset until it is derecognized or when it is no longer classified as investment property; fair value is determined at the end of each financial year; fluctuations in fair value from one financial year to another affect income or expenses, as appropriate; investment property measured at fair value is not depreciated.

Entities applying IAS 40 may switch from the cost model to the fair value model at any time during the year, but the switch from the fair value model to the cost model is not permitted, which means that the assets in question will be measured at fair value until derecognition or until a use change occurs.

In Table 1, we present a comparative analysis of the accounting treatments involved in using the cost or fair value model in the case of the two accounting frameworks.

Table no. 1 Accounting treatment for the cost/fair value model

The cost-based model (OMFP 1802/2014 și IAS 40)	The fair value model (IAS 40)
Initial recognition of the investment property: 215 = 404 (entities applying OMFP 1802/2014) 2152 = 404 (entities applying IFRS)	Initial recognition of the investment property: 2151 = 404
Amortization of the investment property: 6811 = 2815	Not amortized
Transition to the fair value model (year-end revaluation of the investment mproperty): Cancellation of depreciation: 2815 = 215 A. Negative difference: EXPENSE = 215 / 2152 or 105 = 215 / 2152 or % = 215 / 2152 105 EXPENSE B. Positive difference: 215 / 2152 = 105 or 215 / 2152 = INCOME or 215 / 2152 = % INCOME 105	Moving to the fair value model: Cancellation of depreciation: 2815 = 2151 A. Fair value loss (decrease in fair value): 6561 = 2151 B. Gain on measurement at fair value (increase in fair value): 2151 = 7561
Continue to depreciate the asset at fair value: 6811 = 2815	Derecognition of the asset by sale: 461 = 7562 6562 = 2151

5. DISCUSSION

To shed light on the effects that the application of the cost-based or fair value-based model can produce in the subsequent valuation of real estate investments, we will analyze relevant opinions expressed in the specialized literature.

Olante and Lassini (2022) suggest that there may be various reasons that could lead to the option for fair value valuation: contractual efficiency reasons, asset pricing incentives related to information asymmetries, institutional factors in the country and industry, etc. However, the option for fair value seems to be more associated with the institutional factors of the country, especially the development of capital markets and legal origin, with firms operating in countries where markets are more developed being more oriented towards fair value (Olante and Lassini, 2022). At the same time, another factor that may influence the decision to choose the fair value model is accounting discretion. According to Chem et al (2020), firms with higher needs for accounting

discretion will be more likely to choose the fair value model, since this option is also accompanied by the intention to manipulate reported earnings.

On the other hand, we also note the opinion of Hsu and Wu (2018) who argue that according to IAS 40 entities are required to establish fair value anyway, regardless of the chosen valuation method, because entities that opt for the cost-based model must also disclose fair values in the explanatory notes and explain why fair value cannot be measured reliably.

Profitable firms and firms in the real estate industry are more oriented towards the cost model than the fair value model, with taxation complexity being the main reason for avoiding the fair value model, while firms with a high percentage of institutional investors and higher growth are less likely to use the cost model (Wahyuni et al, 2019).

Mita and Siregar (2019) consider that it is less likely for a highly leveraged company to choose the fair value method, the motivation to reduce information asymmetry being associated with the choice of the fair value-based method, while opportunistic motivation was not associated with such a choice.

In this context, Acaranupong (2017) argues that the cost model is more relevant than the fair value model and that accounting choices are significantly affected by profitability and entity size, with firms with higher earnings predominantly using the cost model. However, Olante and Lassini (2022) argue that firms that hold a higher share of investment property in total assets are more likely to opt for fair value than firms for which IAS 40 assets are less significant.

However, the scientific literature rather indicates that the option for the fair value model brings with it both advantages and disadvantages.

Advantages of fair value valuation:

- reporting investment property at fair value provides better predictive ability for future income than historical cost, as recognizing valuation gains and losses in financial statements can improve the predictability of a firm's future income (Hsu and Wu, 2020);

- the beneficial effects of fair value reporting are associated with institutional characteristics, such as the legal system, the degree of market development, etc., but also with concerns regarding the reliability of fair value estimation and the independence of the valuer, and fair value reporting is generally associated with a higher level of value relevance for investors (Khelil and Khlif, 2024);

- the usefulness of the information provided by financial statements increases when real estate investments are valued based on fair value compared to historical cost (Galera and Pérez López, 2009);

Disadvantages of fair value measurement:

- fair values are less verifiable and difficult to estimate and are therefore unreliable, especially for assets for which there are no active and mature markets; fair value can facilitate information transparency or mask the real value of assets due to managerial estimates, discretion or manipulation (Hsu and Wu, 2018);

- fair value accounting can induce earnings manipulation in a weak institutional environment (Bi et al, 2024);

- entities that adopt the fair value model to measure investment property have lower accounting quality than other firms and the adoption of the fair value model should be carefully considered (Chen, 2011);

- estimating fair value for investment property requires an active real estate market, which makes the application of this standard more difficult (Anić-Antić et al, 2006);
- although they are considered less biased and more accurate measurements of the selling price than historical costs, fair value-based valuations underestimate actual selling prices (Dietrich, 2000);
- fair value accounting is perceived as less objective and verifiable, with the size of the firm potentially influencing the opinion on the impact of fair value on the relevance and reliability of financial statements (Galera and Pérez López, 2009);
- the net asset value usually deviates from the market capitalization of real estate companies, these deviations being the result of insufficient reliability of estimates of the fair value of investment property due to the limitations of valuations, the diversity of approaches applied in valuation and the reliability problem for the mark-to-model approaches usually applied in determining the fair value of investment property (Nellesen and Zuelch, 2011).

6. CONCLUSIONS

Although entities that own investment property and apply the IFRS-based reference framework have the option of opting for either the cost-based model or the fair value-based model, the choice of one of the two is not very well defined in the practice of economic entities.

It seems that managers select between the permitted methods according to certain set objectives such as reporting higher earnings, facilitating asset sales, standardizing reported changes in earnings, standardizing changes reported in net assets, increasing fair values before incurring new liabilities, etc. (Dietrich et al., 2000).

At the same time, fair values reported for investment property are considered to be associated with more risk of collapse than when historical cost is used. In countries where corporate governance is well regulated, such as European countries, investment property valued at fair value provides more relevant information and reduces information asymmetry, but in countries such as China, valuation according to the fair value model decreases corporate transparency and increases the risk of collapse (Hsu and Wu, 2018). It can also be concluded that the use of fair value reporting for investment property in emerging markets may be associated with certain managerial opportunism (Chen et al., 2020).

On the other hand, company size and market-to-account ratio are negatively associated with the choice of fair value, while ownership dispersion increases the probability of choosing the fair value approach (Khelil and Khlif, 2024).

In this context, the results of the analysis suggest that the advantages and disadvantages associated with each of the two models do not clearly decide the discussion in favor of one of them.

Our study may also have some limitations. First, we believe that using a single database to analyze the relevant literature may leave out valuable works that contain important ideas for the final conclusions. Extending the research to other databases, such as Scopus, could add value to the research. At the same time, beyond the opinions expressed in the literature, we believe that it would be interesting to analyze the views of managers on the subject under discussion. Thus, a future research topic could

consider processing the data obtained by conducting a survey among managers and accountants on the reasons behind choosing one of the two models.

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