The background of the cover is a nighttime photograph of a city skyline. Several tall skyscrapers are visible, many of which are under construction, as evidenced by the presence of cranes and the skeletal structures of the buildings. The windows of the completed parts of the buildings are lit up, and the lights from the construction site are visible. A prominent yellow diagonal graphic cuts across the right side of the image, starting from the top right and extending towards the bottom left. The overall scene is reflected in a body of water in the foreground.

IFRS for real estate: current issues and financial statements survey

January 2011



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1 Executive summary and key findings

Welcome to our latest proprietary survey of financial statements – and an analysis of some of the key financial reporting issues – of real estate investors reporting under IFRS. This year, we again focus on the issues likely to be significant in a still challenging real estate market.

Whilst we found that the uncertainty that dominated real estate markets in 2009 has led to some increase in the level of disclosure on property valuations, the qualitative and quantitative information disclosed still differs from company to company. Some companies include very little specific information in relation to uncertainty, whilst others disclosed detailed information on the assumptions, sensitivities, uncertainty in the valuations and debt covenants. IFRS is subject to various levels of judgment. The extent to which that judgment has been applied in financial statements also differs from company to company.

We report the following survey highlights:

1. As in prior years, more than 90% of companies have adopted the fair value option available in IAS 40 *Investment Property* for the measurement of their investment property.
2. Consistent with previous year, most companies have had their portfolio valued by external valuers (68%).
3. The DCF method is gaining in popularity.
4. The number of companies who disclosed the assumptions applied in the valuation of investment property has increased from 35% to 54% compared with last year.
5. Also the number of companies who reported valuation sensitivity analyses increased compared to last year (from 25% to 45% of the surveyed companies).
6. As we had expected, the absence of detailed guidance on the reliable measurement of fair values of Investment properties under construction has resulted in a wide divergence in practice. We continue to recommend that valuation standard setters address this matter in more detail by providing more detailed guidance.
7. 50% of the surveyed companies presented investment properties under construction on the face of the balance sheet, separate from completed investment properties.
8. Our findings in respect of the disclosure of assumptions applied in valuing investment property under construction and sensitivity analysis thereof are more or less similar to those described above with respect to completed investment property.
9. 15 companies (40%) in our survey have recognised goodwill on the balance sheet, of which, one company explicitly disclosed that the goodwill arose due to a portfolio premium, three in relation to acquiring a management platform, and three of them disclosed that the goodwill was due to deferred tax liabilities.
10. 60% of respondents disclosed that they applied the VIU method to test goodwill for impairment.
11. In our prior year survey, we noted that more companies disclosed information on impairment testing of goodwill and assumptions. This trend has continued in 2009.
12. 21% of the companies surveyed disclose whether they consider acquisitions a business combination or an acquisition of an asset.
13. The majority of the companies declared that deferred tax is provided for using the liability method for all temporary differences at the reporting date between the tax bases of assets and liabilities and their carrying amounts. However, two companies were less clear on how they provided for taxes, one used a portfolio approach and one company disclosed no accounting policy at all.
14. Almost all companies (92%) have included information in the financial statements with respect to compliance with debt covenants; most companies included actual covenants applicable and the situation as per balance sheet date.
15. Sixteen companies (45%) reported service charges on a gross basis; they separately disclosed service income and expenses, either on the face of the income statement or in the notes thereto.
16. Of those companies who have joint ventures, 38% applies the equity method and 62% applies the proportionate consolidation method. This suggests that with the forthcoming changes under the new standard Joint arrangements, many may have to move from proportionate consolidation to equity accounting.
17. The new standard IFRS 8 *Operating Segments* has not led to significant changes in segment reporting.



2 The survey

The *Ernst & Young IFRS Real Estate Survey* provides an overview of the accounting policies and disclosures in the financial statements of property companies from Europe, Australia and the Middle East. This year, we further increased the number of companies surveyed from 30 to 38.

In our previous surveys, we analysed a number of issues, including the accounting policies and disclosures in relation to the measurement of investment and development property, debt covenants compliance and goodwill. In this survey, we included deferred taxes, service charges, joint venture accounting and segment reporting. With respect to the items “definition of a business” and deferred accounting, we also looked ahead for upcoming changes.

The companies included in our survey are as listed below:

Company	Location	Financial year-end
General Property Trust ('GPT')	Australia	31 December 2009
Goodman International Limited ('Goodman Group')	Australia	30 June 2010
Stockland Trust ('Stockland')	Australia	30 June 2010
Westfield Group (Westfield Holdings Ltd & controlled entities) ('Westfield')	Australia	31 December 2009
Immofinanz AG ('Immofinanz')	Austria	30 April 2010
Cofinimmo SA ('Cofinimmo')	Belgium	31 December 2009
Beffimmo SCA ('Beffimmo')	Belgium	30 September 2009
Sponda PLC ('Sponda')	Finland	31 December 2009
Foncière des Régions SA ('Foncière')	France	31 December 2009
GECINA ('Gecina')	France	31 December 2009
Klépierre SA ('Klépierre')	France	31 December 2009
Icade S.A. ('Icade')	France	31 December 2009
Unibail – Rodamco SA ('Unibail-Rodamco')	France/Netherlands	31 December 2009
Deutsche Annington Immobilien GmbH ('Deutsche Annington')	Germany	31 December 2009
Deutsche Wohnen AG ('Deutsche Wohnen')	Germany	31 December 2009
IVG Immobilien AG ('IVG')	Germany	31 December 2009
GAGFAH SA ('GAGFAH')	Germany	31 December 2009
Hong Kong Land Limited ('Hong Kong Land')	Hong Kong	31 December 2009
Gazit-Globe Limited ('Gazit-Globe')	Israel	31 December 2009
Beni Stabili S.p.A ('Beni Stabili')	Italy	31 December 2009
Pirelli & C. Real Estate S.p.A. ('Pirelli')	Italy	31 December 2009
Corio NV ('Corio')	Netherlands	31 December 2009
Wereldhave NV ('Wereldhave')	Netherlands	31 December 2009
Goodman Industrial Trust ('Goodman Trust')	New Zealand	30 June 2010
Globe Trade Center S.A ('GTC')	Poland	31 December 2009
Inmobiliaria Colonial, S.A ('Inmobiliaria')	Spain	31 December 2009
Castellum AB ('Castellum')	Sweden	31 December 2009
Fabege AG ('Fabege')	Sweden	31 December 2009
Kungsleden AB ('Kungsleden')	Sweden	31 December 2009
PSP Swiss Property Group Ltd ('Swiss Property')	Switzerland	31 December 2009
Züblin Immobilien	Switzerland	31 December 2009
ALDAR Properties PJSC ('Aldar')	UAE	31 December 2009
EMAAR Properties PJSC ('Emaar')	UAE	31 December 2009
The British Land Company PLC ('British Land')	UK	31 March 2010
Hammerson PLC ('Hammerson')	UK	31 December 2009
Land Securities Group PLC ('Land Securities')	UK	31 March 2010
Derwent London PLC ('Derwent')	UK	31 December 2009
Segro PLC ('Segro')	UK	31 December 2009



3 Measurement of investment and development property and related disclosures

3.1 Introduction

Many believe that real estate valuations have an inherently high degree of uncertainty. The financial crisis certainly bears this view out. Even the RICS, in its 2009 Sales and Valuation report, stated that *“The financial crisis has also raised awareness of the need for those relying on valuations to understand the certainty that can be attached to them”*. Let's have a look at some data from these RICS reports:

Country	Properties sold within +/- 10% of valuation				Properties sold within +/- 20% of valuation			
	2009	2008	2007	2006	2009	2008	2007	2006
France	63%	49%	40%	50%	86%	79%	64%	70%
Germany	53%	60%	48%	43%	69%	77%	73%	67%
The Netherlands	65%	62%	50%	45%	88%	85%	82%	79%
UK	55%	60%	60%	64%	82%	83%	85%	88%
Unweighted average	59%	58%	50%	51%	81%	81%	76%	76%

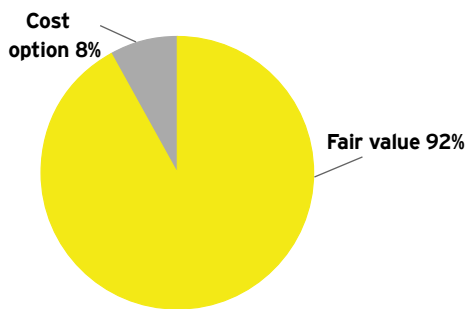
So is the glass half empty or half full? The table above demonstrates that many real estate sales transactions (40% or more) were concluded at a price that departed more than 10 per cent from the latest valuation and close to 20% of transactions departed by more than 20%.

The answer to valuation uncertainty from a financial statement perspective is often full transparency and disclosure of the valuation methods applied and the significant estimates and assumptions used. A meaningful sensitivity analysis indicating how fair values could fluctuate when assumptions would be different is also important.

In view of the above, it is interesting to see how well the property sector has responded to this transparency challenge.



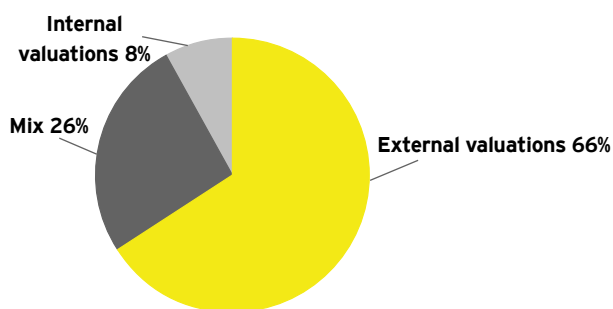
3.2 The fair value model versus the cost option for investment property



Fair value vs cost option

Almost all of the companies (92%) in our survey have adopted the fair value option available in IAS 40 for the measurement of their investment property. Three companies, Klépierre, Icade and Emaar, measured investment property at cost. Klépierre provided additional *pro forma* financial data that presents its investment property on a fair value basis. Emaar also disclosed the fair values of the individual properties whilst Icade provided more details including a table setting out fair values per asset category (residential, business parks, office-France, office-Germany and other) and also disclosed the valuation methods applied.

3.3 External or internal valuations



Valuations as per balance sheet date

Consistent with previous year, most companies have had their portfolio valued by external valuers (66%). Three companies (8%) valued their portfolio internally and nine companies (26%) valued their property partly internally and partly externally. In most cases where internal valuations were used at year-end, external valuations were performed during the year on a part of the portfolio or external valuations were used to confirm the internal valuations. Castellum requested external valuations to provide further assurance and validation of internal valuations:

“In order to provide further assurance and validation of the valuation 129 properties, representing 51% of the value of the portfolio, were valued by NAI Svefa. The properties were selected on the basis of the largest properties in terms of value, but also in order to reflect the composition of the portfolio as a whole in terms of category and geographical location of the properties. NAI Svefa’s valuation of the selected properties amounted to SEKm 14,981, within an uncertainty range of +/- 5-10% on property level. The size of the uncertainty range varies depending on each property’s category and location. Castellum’s valuation of the same properties amounted to SEKm 14,990, i. e. a net change of SEKm 9 corresponding to 0.1%. Gross deviation was SEKm +495 respectively SEKm -504 with an average deviation of 7%.”

3.4 Valuation methodology

Introduction

IAS 40 defines fair value as ‘the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction’. Paragraphs 38 to 52 of IAS 40 provide a substantial amount of guidance on the methodology for valuing investment property. Fair value reflects market conditions as at the balance sheet date and is a valuation as at a specific moment in time. It assumes simultaneous exchange and completion, to avoid the variations in price that might otherwise take place. The fair value of the property is driven, at least in part, by the rental income from tenants and, if appropriate, outflows such as rental payments. It is further assumed that the valuation is based on assumptions that would be considered to be reasonable and supportable by willing and knowledgeable parties.

The standard states that the best evidence of fair value will be given by comparable transactions in similar properties in a similar location and condition. However, it allows the fair value to be estimated by using other information when market values are not available. The other information that an entity may draw on includes (IAS 40 paragraph 46):

- “(a) Transactions in an active market for dissimilar property (e.g. property of a different nature, condition or location, or subject to a different type of lease), as adjusted to reflect the differences;
- (b) Transactions in less active markets if they have been adjusted to take account of subsequent changes in economic conditions; or
- (c) Discounted cash flow projections based on estimated future cash flows (as long as these are reliable). These should be supported by existing leases and current market rents for similar properties in the same location and condition. The discount rate should reflect current market assessments of the uncertainty and timing of the cash flows.”

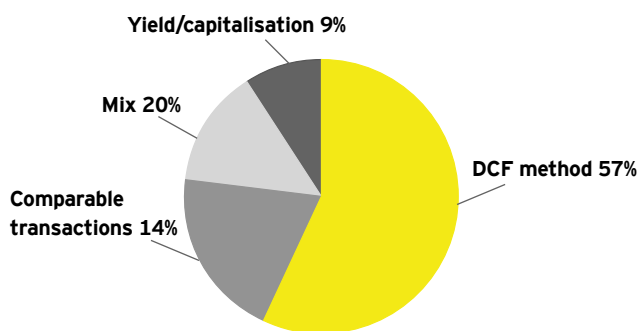
In addition, paragraph 75 d of IAS 40 requires disclosure of the methods used in fair valuing investment property.



Survey results

Against this background, let's have a look at the survey results.

Valuation methods



Deutsche Annington describes their valuation policy as follows:

"The best evidence of fair value of investment properties is current prices in an active market for comparable properties. If, however, such information is not available, DAIG uses standard valuation techniques such as the income capitalisation method. In determining the fair value by using the income capitalisation method, DAIG takes, among others, the following estimates and assumptions into consideration: the annual net rent, future anticipated rental income, void periods and administrative and maintenance expenses. The interest rate to determine the capitalised value is derived by using a rating system. DAIG regularly compares its valuations to actual market data as well as to actual transactions."

Our survey showed that the DCF method is applied for the valuation of their portfolios by 20 companies (57%), the comparable transaction method by five companies (14%) and the yield/capitalisation method by three companies (9%). Seven companies used a mix of valuation methods (20%). It will be interesting to see how this trend evolves in the future; there is a growing tale of two practises whereby the DCF method grows in popularity in Europe, with the exception of the UK market, where the income capitalisation method remains the most favoured method.

Given the fact that the transaction volumes were still low at the end of 2009 and comparable transaction in the market were hardly available, the outcome that only five companies applied the comparable transactions method is not a surprise.

3.5 Assumptions

Paragraph 75d of IAS 40 requires the disclosure of the methods and significant assumptions applied:

"the methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily base on other factors (which the entity shall disclose) because of the nature of the property and lack of comparable market date."

In Good Real Estate (International) Group 2010, our illustrative set of consolidated financial statements, prepared in accordance with International Financial Reporting Standards (IFRS), we recommend the following minimal disclosure per operating segment:

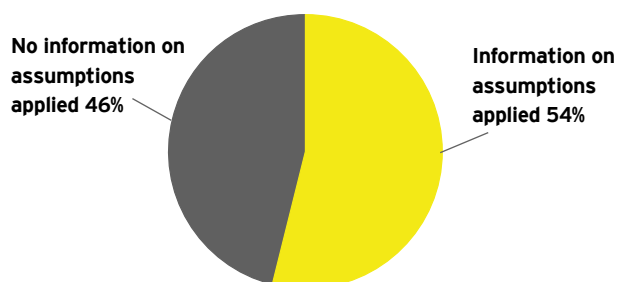
- ▶ Passing rent per sqm
- ▶ Estimated rental value (market rent) per sqm
- ▶ Average net initial yield
- ▶ Reversionary yield
- ▶ Inflation rate
- ▶ Long-term vacancy rate
- ▶ Long-term growth in real rental rates

Over the past years, we have seen a (significant) increase in the quantity and quality of the assumptions disclosed by the companies in our survey. We believe this is mainly driven by the uncertainty in the markets and the increased attention by users of the financial statements on these assumptions.

In the 2008 financial statements, 35% of the surveyed companies disclosed information on the assumptions applied. This has increased to 54% of the surveyed companies in 2009.

Most of these disclosures comprised base data normally applied in valuation calculations like interest rates, inflation, occupancy rate, key risks and other key valuation inputs. Some companies added further precision by segregating the assumptions into categories by property type or geographic area.

Information assumptions on valuations





Wereldhave provided an informative table of the various key valuation inputs used by their external valuation specialists as shown below.

	Belgium	Finland	France	The Netherlands	Spain	United Kingdom	United States
Theoretical rent per sqm (€)	192	290	276	112	147	192	204
Average net initial yield	6.2%	5.9%	6.4%	6.5%	7.1%	8.2%	7.1%
Average vacancy rate	7.2%	1.0%	62.5%	0.6%	10.1%	8.7%	9.8%

Another example of a quantitative disclosure of the assumptions comes from **GPT**.

The key assumptions (on the basis of weighted averages) used in the valuations of investment properties as at 31 December are:

Consolidated entity	31 Dec 09 \$m	31 Dec 08 \$m
Retail portfolio:		
Weighted average Cap Rate (%)	6.3%	6.0%
Total Portfolio Retail Occupancy Rate	99.6%	99.5%
Total Portfolio Specialty MAT (\$psm)	9,114	8,838
Total Portfolio Specialty Occupancy Cost	16.8%	16.6%
Office portfolio:		
Weighted average Cap Rate (%)	7.3%	6.6%
Total Portfolio Occupancy Rate (%)	95.6%	99.0%
Weighted Average Lease Term by Area (Years)	5.2	5.2
Industrial portfolio:		
Weighted average Cap Rate (%)	8.4%	7.9%
Total Portfolio Occupancy Rate (%)	96.5%	100.0%
Weighted Average Lease Term by Income (Years)	7.2	7.2



Swiss Property provided a detailed table of discount rates per region and long term market rents and a quantitative overview of general assumptions applied to the property valuation.

“Investment properties

The following nominal discount rates were applied to the property valuation:

Table 1: Region	Minimum discount Rate (%)	Maximum discount Rate (%)	Mean discount Rate (%)
Zurich	4.8	6.6	5.7
Geneva	5.1	6.1	5.6
Basel, Berne, Lausanne	5.2	7.3	5.9
Other regions	5.5	7.2	6.2
All regions	4.8	7.3	5.7

Average of discount rates for individual valuations, weighted by market value.

The following ranges for achievable long-term market rents were applied to the property valuations:

Table 2: Region	Office CHF/M ² P.A.	Retail CHF/m ² P.A.	Warehousing CHF/m ² P.A.	Outdoor parking CHF/NR P.M.O.	Indoor parking CHF/NR P.M.O.	Housing CHF/M ² P.A.
Zurich	110 – 950	200 – 6,700	40 – 550	60 – 450	90 – 700	130 – 620
Geneva	310 – 800	330 – 3,600	25 – 500	120 – 450	100 – 500	250 – 350
Basel, Berne, Lausanne	80 – 350	90 – 1,900	30 – 500	80 – 240	50 – 460	130 – 380
Other regions	90 – 425	150 – 2,000	30 – 240	30 – 150	80 – 400	160 – 350
All regions	80 – 950	90 – 6,700	25 – 600	30 – 450	50 – 700	130 – 620

Excluded is the property Brandschenkestrasse 152 a, Zurich, which is owner-occupied.

The investment property valuations are based on the following general assumptions:

1. The rent rolls from PSP Swiss Property used in the valuation are dated 1st January 2010.
2. A one-phase DCF model was adopted. The valuation period extends for 100 years from the valuation date, with an implicit residual value in the eleventh period.
3. Discounting is based on a risk-adjusted interest rate. Rates are determined individually for each property on the basis of appropriate benchmarks derived from arm's-length transactions. They may be broken down as follows: risk-free interest rate + property risk (immobility of capital) + premium for macro-location + premium for micro-location depending on use + premium for property quality and income risk + any other specific premiums. Nominal discount rates range between 4.8% and 7.3% depending on the property, use and location (see Table 1).



4. Unless otherwise stated, the valuations assume 1.2% annual inflation for income and all expenditure. Where a nominal discount is applied, this is adjusted accordingly.
5. Credit risks posed by specific tenants are not explicitly factored into the valuation.
6. Specific indexation of existing rental agreements is accounted for on an individual basis. After expiry of the contracts, an indexation factor of 80% (Swiss average) and an average contract term of 5 years are assumed.
7. For existing tenancies, the timing of individual payments is assumed to comply with the terms of the lease. Following lease expiry, cash flows for commercial premises are taken as quarterly in advance and for housing, monthly in advance.
8. In terms of running costs, entirely separate service charge accounts are assumed, with no tenancy-related ancillary costs to be borne by the owner.
9. The maintenance (repair and upkeep) costs were calculated using a building analysis tool. This tool is used to estimate the remaining lifespan of individual components based on their present condition, to model periodic refurbishments and to calculate the associated annual renewal fund allowances. The calculated values are plausibility tested using cost benchmarks derived from Wüest & Partner surveys."

3.6 Sensitivity analyses and uncertainty in valuations

Paragraph 125 of IAS 1 stipulates that an entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. Paragraph 129 subsequently determines that disclosures shall include:

"(a) the nature of the assumption or other estimation uncertainty;

(b) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;

(c) the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and

(d) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved."

As noted previously, the number of companies who disclosed the assumptions applied in the valuation of investment property has increased compared to last year. Also the number of companies who included a sensitivity analysis in the disclosure increased from 25% to 45% of the surveyed companies.

In most cases, the impact of a 25 to 100 bp (basis points) yield change on property value has been disclosed. An example is provided by Goodman Group:



The table below shows the sensitivity of the fair value of those stabilised investment properties which have been internally valued to a 25 basis point increase in the annual discount rate. All other assumptions are property specific and it is impractical to show sensitivities.

Division	Decrease in investment property values (Goodman properties)		Goodman share in decrease in investment property values (managed funds)	
	2010	2009	2010	2009
Australia	(7.0)	(40.7)	n/a ¹	(25.3)
Logistics – United Kingdom	(1.4)	(0.9)	n/a ¹	(9.7)
Logistics – Continental Europe	n/a ¹	(8.2)	n/a ¹	n/a ¹
Business Parks – United Kingdom	n/a ¹	–	n/a ¹	(15.5)

¹ Adjustments were made to the carrying value of stabilised investment properties arising from internal valuations at 30 June 2010 for Goodman properties in Australia and Continental Europe only.

Some companies provided more detailed analyses on sensitivities and real estate market risks. **Züblin** for example included a paragraph dealing with real estate market risks in the risk paragraph. Information similar to IFRS 7 financial risk disclosure information was disclosed. Two graphs showing the sensitivity of the property valuations to a change in the discount rates as well as to changes in the market rents were also included. Additionally, the following qualitative information was included:

“The management of real estate market risks is one of the core competencies of the Züblin Group. Essentially, these risks are comprised of two specific categories – real estate market cycle risk and rental market risk.

Real estate market cycle risks are related to fluctuations inherent to the overall commercial real estate market and the related impact on the valuations of the Züblin Group’s investment portfolio. These risks can be partially mitigated by the Züblin Group’s strategy of geographical diversification. Risks in connection with a change in discount rates as well as market rents are risks that affect the entire property market. Following are two sensitivity analyses which show the impact on the property valuations in each country where Züblin is invested.

Rental market risks relate to the use of the property, the tenant mix, the credit standing of the tenants, the vacancy rate, the ability to increase rents, and the recoverability of running costs. Through its local internal asset management activities, the Company is constantly managing controllable risk factors, and is focused on proactively mitigating these risks where possible. Group Management meets routinely, and as part of its agenda evaluates the overall concentration risk of its tenant structure, reviews any material changes to the credit standing of its significant tenants, as well as current or pending changes to the vacancy rates in all markets. Where necessary, the Board of Directors is alerted to material changes in the Züblin Group’s specific risk profile.”

Four companies explicitly disclosed qualitative information in relation to the uncertainty surrounding valuation assumptions. **GTC** for example disclosed the following around market uncertainty:

“The continued instability in the financial markets causes volatility and uncertainty in the world’s capital markets and real estate markets. There is a low liquidity level in the real estate market and transaction volumes are significantly reduced, resulting in a lack of clarity as to pricing levels and the market drivers. As a result there is less certainty with regard to valuations and market values can change rapidly due to the current market conditions”



Five companies disclosed the uncertainty in valuation in more general wording and not specifically linked to the economic crisis. **Kungsleden** for example disclosed the following:

“Properties are not listed on a marketplace. Property values depend on innumerable factors like property type, place and location, size, length of rental contract and rent level, tenant structure, technical standard, etc. Different appraisers make different judgments, and thus obtain different values. Funding terms, interest rate levels and a functional financial market also affect the pricing and required returns that create balance on the property market between buyers and sellers. The value interval between an appraised value and sales value is normally in the range of +/- 5 to 10 per cent on a functioning market”.

3.7 Investment property under construction

Introduction

As part of the 2008 annual improvement process, the IASB amended IAS 40 to include investment property under construction within its scope for periods beginning on or after 1 January 2009. The IASB, allowed that entities apply these changes prospectively. Perhaps the most debated paragraph in IAS 40 in this respect is paragraph 53, which states:

“If an entity determines that the fair value of an investment property under construction is not reliably determinable but expects the fair value of the property to be reliably determinable when construction is complete, it shall measure that investment property under construction at cost until either its fair value becomes reliably determinable or construction is completed (whichever is earlier).”

With absence of specific guidance, both in IFRS and valuation standards, it is interesting to see how companies deal with this reliability threshold.

Survey results

In last year’s survey, we noted that three companies (10% of the surveyed companies who held property under construction) early adopted this change in the accounting principles. Starting from the financial year 2009, all companies who measure their completed investment property at fair value – and as reported earlier in our survey, almost all property company do so – also needed to measure their investment property under construction at fair value.

Twenty six of the companies that apply the fair value model for their completed investment properties also have property under construction. All of the companies who changed the accounting policy in 2009 applied the new requirements prospectively from 2009 for all investment property under construction. One company recognised the transitional effect directly through equity; the other companies recognised the effect through the income statement.

Some of the surveyed companies disclosed in their accounting policies the criteria adopted in assessing as to whether the fair value can be determined reliably. For example, **Unibail Rodamco** disclosed the following:

“The pipeline project is eligible for a fair value measurement once all three following criteria are fulfilled:

- ▶ All administrative authorisations needed to complete the project are obtained,
- ▶ The construction has started and costs are committed toward the constructor,
- ▶ Substantial uncertainty in future rental income has been eliminated.

If the time to delivery is less than one year, the project has to be taken at fair value.”

Other companies are of the opinion that fair value can be determined at an earlier stage in the development cycle, for example, **Swiss Property** stated:

“Swiss Property assumes that a reliable determination of the fair value according to IAS 40 is possible from the moment a concrete project with corresponding building permission is available.”



GTC discloses:

"The Company has decided to revalue only IPUC, for which a substantial part of the development risks have been eliminated. Assets, for which this is not the case or construction has not yet started are presented at the lower of cost or recoverable amount. The Company has adopted the following criteria to start assessment whether the substantial risks are eliminated with regard to particular IPUC:

- ▶ Agreement with general contractor is signed;
- ▶ Building permit is obtained;
- ▶ At least 20% of the rentable area is leased to tenants (based on the signed lease agreements and letter of intents)."

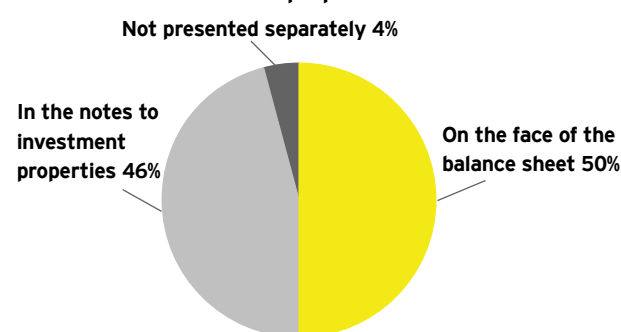
Not surprisingly, due to the long standing practice of fair valuing Investment Properties under Construction at fair value, most UK companies do not mention any issue with assessing the fair value of investment property under construction.

The absence of detailed guidance on reliability, has resulted in a wide range of practices. We continue to recommend valuation standard setters to address this matter in more detail by providing more detailed guidance.

Presentation

Around 50% of the surveyed companies presented the investment properties under construction on the face of the balance sheet, separate from completed investment properties or – terminology also used – stabilised investment property. The other companies disclosed the information in a table in the notes, except for one company which did not disclose any information at all.

Presentation investment properties under construction



An example of a table distinguishing between completed investment properties and investment properties is provided by Goodman Group:

Division	Completed investment properties		Investment properties under construction		Total investment properties	
	2010	2009	2010	2009	2010	2009
Carrying amount at the beginning of the year	2,332.1	2,790.6	538.6	655.4	2,870.7	3,446.0
Acquisitions:						
▶ On acquisition of controlled entities	–	23.9	–	–	–	23.9
▶ Other acquisitions	–	34.8	13.9	67.5	13.9	102.3
Transfers in from other assets	–	–	–	37.7	–	37.7
Capital expenditure	19.5	219.4	20.6	-56.7	40.1	162.7
Transfers in/(out)	138	–	-138.0	–	–	–
Disposals						
▶ Carrying value of properties sold	-20.2	-147.3	-8.3	-41.4	-28.5	-188.7
▶ On disposal of interests in controlled entities	-79.5	-120.8	–	-90.1	-79.5	-210.9
▶ Transfers to asset held for sale	–	-157.3	–	–	–	-157.3
Transfers to inventory	–	–	-104.0	–	-104.0	–
Net loss from fair value adjustments	-81.7	-334.9	-51.0	-39.8	-132.7	-374.7
Effect of foreign currency translation	-63.9	23.7	-15.9	6.0	-79.8	29.7
Carrying amount at the end of the year	2,244.3	2,332.1	255.9	538.6	2,500.2	2,870.7



GTC also separately categorised its investment property and disclosed fair values under the following headings:

- ▶ Completed investment property
- ▶ Investment property under construction at fair value
- ▶ Investment property under construction at cost

Given the specific risks to properties under construction, we would expect these to be presented separately on the face of the balance sheet. Following IAS 40, paragraph 78, we would also have expected further segmentation of properties under construction carried at fair value and those presented at cost. The survey results presented above do not fully confirm this best practice.

Assumptions and sensitivity analysis

Disclosures on assumptions applied and sensitivities are also found to be necessary given the risks and uncertainties in these valuations. Our findings in this respect are more or less similar than those presented in paragraph 3.5 and 3.6.

4 Goodwill

Sources of goodwill

Goodwill in the real estate sector might typically arise on the acquisition of a business due to the following factors:

- ▶ Goodwill created by synergies of the acquired portfolio and synergies of combining portfolios (e.g., anticipated abilities of the acquired management /development team to outperform the market or economies of scale)
- ▶ Goodwill arising from overpayments or errors in fair value measurement
- ▶ Goodwill created by the requirement to measure identifiable items that are not at fair value – typically deferred tax

We also refer you to our publication *Goodwill hunting*¹ on the treatment of goodwill.

15 companies (40%) in our survey recognised goodwill on the balance sheet, of which one company explicitly disclosed that the goodwill arose due to a portfolio premium, three in relation to acquiring a management platform and three disclosed that the goodwill was due to deferred tax liabilities.

Cofinnimo disclosed the following:

“From an accounting point of view, this acquisition is treated as a business combination in the meaning of IFRS 3. The situation at the acquisition is considered as being the situation taking into account the operation concluded on 27.11.2008. The total acquisition price of this participating interest amounts to €388.3 million. During the valuation of Pubstone’s assets and liabilities at their fair value, an amount of goodwill has appeared, corresponding to the difference between the acquisition price and the fair value of the acquired net assets. In order to illustrate the calculation of this difference, Pubstone’s acquisition balance sheet, consolidated with its Dutch subsidiaries, expressed in fair value, is presented hereafter.”

¹ Available at ey.com/ifrs.



Goodman Group discloses the following with respect to management rights:

“As distinct from goodwill, management rights acquired as part of a business combination are recognised if the asset is separable or arises from contractual or other legal rights, and its fair value can be measured reliably. Management rights, including indefinite life contracts to manage assets, are carried at cost less accumulated amortisation and impairment losses. Where management rights are for an indefinite term and/or where renewal of rights is routinely renewed at minimal cost, no amortisation is provided but the rights are subject to an annual impairment test (refer to note 1(n)). Where management rights are for a finite period, they are amortised on a straight-line basis over that term.”

Impairment testing

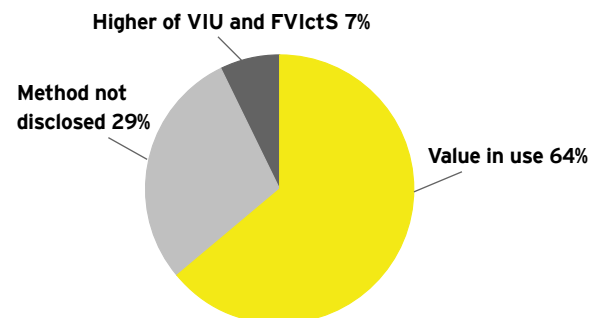
IAS 36 requires the carrying amount of the goodwill to be compared with the recoverable amount, which is the higher of “Value in use” (VIU) and “Fair Value less cost to sell” (FVLCS). If either the FVLCS or the VIU is higher than the carrying amount, no further action is necessary as the goodwill is not impaired. IAS 36 defines VIU as the present value of the future cash flows expected to be derived from an asset or Cash Generating Unit and FVLCS as the amount obtainable from the sale of an asset or Cash Generating Unit in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal.

Nine out of the fifteen companies (i.e., 60%) disclosed that they applied the VIU method to test goodwill for impairment. Four companies did not disclose the methods applied and only referred to the ‘recoverable amount’ and one disclosed that they applied the higher of the two. The companies that only mentioned one method might not have considered the other method as their first method did not lead to a potential impairment.

Two companies specifically mentioned that they perform the impairment test on the basis of VIU as there had been limited information available on fair values given the lower volume of comparable transactions during the year.

Goodwill impairment method

Additional disclosures



IAS 36 also requires that the annual disclosures are intended to provide the user with information about the types of estimates that have been used in arriving at the recoverable amounts of goodwill and intangible assets with an indefinite useful life, that are included in the assets of the company at the period end.

In our prior year survey, we noted that more companies disclosed information on impairment testing of goodwill and assumptions. This trend has continued in 2009.

Cofinimmo, disclosed the projected period, annual indexation of cash flows and discount rate, and also disclosed the following sensitivity table:

Sensitivity analysis of the value in use when the two main variables of the impairment test vary by 0.10% (in %)

Building group	0.10% variation in inflation	0.10% variation in the discount rate
Pubstone Belgium	1.30	1.35
Pubstone The Netherlands	1.32	1.37
Cofinimmo France	1.14	0.04



GPT disclosed the following information in relation to impairment of goodwill in relation to management rights:

“Goodwill, which has an indefinite useful life, is not subject to amortisation and is tested annually for impairment. All other assets, including financial assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Where an indicator of impairment or objective evidence exists, an estimate of the asset’s recoverable amount is made. An impairment loss is recognised in the Statement of Comprehensive Income for the amount by which the asset’s carrying amount exceeds its recoverable amount. Recoverable amount is the higher of an asset’s fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash inflows that are largely independent of the cash inflows from other assets.”

We noted that besides GPT, five other companies recognised impairment on their goodwill. The impairments of the goodwill were mainly due to the change in the markets, for example

Emaar disclosed that:

“On 1 June 2006 (acquisition date), the Group acquired 100% of the voting shares of WL Homes LLC, a residential home builder, an unlisted limited liability company headquartered in Newport Beach, California, United States of America. On the acquisition date, the Group had recorded a goodwill amounting to AED 2,522,577 thousands. The management of the Group had undertaken an impairment review of the goodwill as at 31 December 2008. Based on the review and the Group’s future intentions with respect to restructuring this investment in light of the unprecedented slowdown in the US housing market, the Group had decided to write down the entire goodwill of AED 2,522,577 thousands recorded at the time of acquisition. Subsequently, during the year ended 31 December 2009 the Group has written down its entire net investment in WL Homes LLC.”

Emaar also discloses sensitivity information with respect to goodwill it carries in relation to a property management consultancy company as follows:

“The calculation of value in use is sensitive to the following assumptions:

Gross margins – Gross margins are based on the expectations of management based on past experience and expectation of future market conditions.

Discount rates – Discount rates reflect management’s estimate of the specific risks. The discount rate is based on the risk free rate of the investment’s country, market risk premium related to the industry and individual unit related risk premium/ discount. This is the benchmark used by management to assess performance and to evaluate future investment proposals. Management estimates that such discount rate to be used for evaluation of the investment should be between 9% and 11%.

Growth rate estimates – Management prepares a five year budget based on their expectations of future results, thereafter a growth rate of 0.5% to 1% is assumed.”

Definition of a business

The revised IFRS 3 *Business Combinations*, (IFRS 3R), which is effective for business combinations effected in financial years starting on or after 1 July 2009, has introduced a revised definition of a business compared with the previous version of IFRS 3. The new standard seems to broaden the definition and requires more judgment to be applied, such that more acquisition transactions may be considered as businesses, and, therefore, be accounted for as a business combination, compared with prior practice. The determination of whether an acquired set of activities and assets represents a business is critical because the accounting for a business combination is significantly different from the accounting for an asset acquisition.

Description	IFRS 3R	Existing IFRS 3
Definition of a business	“... an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return ...”	“... an integrated set of activities conducted and managed for the purpose of providing a return ...”

We also refer you to our publication *Definition of a business under IFRS 3R revised* (available at ey.com/ifrs).



Looking ahead, with the upcoming changes in the definition of what constitutes a business, we were wondering what the current disclosures are in this respect.

Eight (21%) of the companies surveyed disclose whether they consider acquisitions a business combination or an acquisition of an asset. Some examples of disclosures:

Unibail – Rodamco 2009 financial statements:

“On May 21, 2008, Unibail-Rodamco acquired 140,400 m² in “Shopping City Süd” in Vienna, Austria. As this involves both the property and the operational and financial management, the acquisition was treated as a business combination.”

In its 2009 report, Unibail Rodamco also states that the Group is currently studying the impact IFRS3R may have and declares that IFRS 3R may bring significant changes to the Group.

ImmoFinanz states in its 2009/2010 annual report:

“The organisational structure required for property management is generally not taken over when the IMMOFINANZ Group acquires a company. However, these objects also need intensive and active post-acquisition management in order to optimise rental income. The IMMOFINANZ staff normally performs these management activities after the acquisition process because the necessary resources are available in the Group and, from the IMMOFINANZ viewpoint, it is more efficient to integrate the relevant property management processes into its own organisation.

Against the backdrop of the management activities required to generate rental income, IMMOFINANZ views these acquisitions as business combinations in the sense of IFRS 3. This standard defines a business combination as the attainment of control (also see section 2.1.2) over the acquired company by the acquirer.”

Hammerson states:

“Management must assess whether the acquisition of property through the purchase of a corporate vehicle should be accounted for as an asset purchase or a business combination. As noted in the accounting policy below, where the acquired company contains significant assets or liabilities in addition to property, the transaction is accounted for as a business combination. Where there are no such items, the transaction is treated as an asset purchase.”

On the other hand, **Kungsleden** states that many share transactions comprise asset deals:

“In recent years, indirect property transactions using companies incorporating such properties have become more common, as opposed to direct property transactions. Asset deals using corporate transactions are reported as if the relevant property/properties had been acquired directly.”

Sponda shares that opinion:

“In the view of management a single property and its lease arrangements do not constitute a business.”

Due to the significant judgment required to conclude whether an acquired set of activities and assets is a business and the significant implications of such determination, companies should carefully evaluate their specific facts and circumstances when applying the new guidance in IFRS 3R.



5 Deferred taxes

Introduction

In many jurisdictions it is common for certain assets (particularly properties) to be bought and sold by transferring ownership of a separate legal entity formed to hold the asset (a 'single asset' entity) rather than the asset itself.

A 'single asset' entity may be formed for a number of reasons. For example, the insertion of a 'single asset' entity between the 'real' owner and the property may limit the 'real' owner's liability for obligations arising from ownership of the property. More pertinent to the current discussion, it may also provide shelter from tax liabilities arising on disposal of the property since, in many jurisdictions, the sale of shares is taxed at a lower rate than the sale of property.

This raises the question whether, in determining the expected manner of recovery of an asset for the purposes of IAS 12, an entity may have regard to the fact that an asset held by a 'single asset' entity can be disposed of by disposing of the shares of the entity rather than the asset itself.

A natural reading of IAS 12 *Income Taxes* would suggest that, where the reporting entity prepares consolidated financial statements (such that the asset held by the 'single asset' entity is included in those financial statements), it is not appropriate to have regard to the possible tax effects of disposing of the shares in the 'single asset' entity rather than the asset itself. This is because paragraph 51 of IAS 12 requires an entity to have regard to the expected manner of recovery or settlement of 'the carrying amount of its assets and liabilities'. Where consolidated financial statements are prepared, the asset recognised in the balance sheet is the property held by, not the shares in, the 'single asset' entity (which are eliminated on consolidation).

However, until the amendments to IAS 12 were published in December 2010, it was argued that the IASB apparently regarded the above position as at least ambiguous. This was because it indicated during the development of the recently published exposure draft that any standard replacing IAS 12 would contain guidance on determining the tax base of an asset when different deductions are available, depending on whether an asset is sold separately or in a 'single asset' entity. However, the IASB has not done that.

In view of the above, it would be interesting to see how companies deal with this issue.

Survey results

The majority of the companies declare explicitly that deferred tax is provided for using the liability method for all temporary differences at the reporting date between the tax bases of assets and liabilities and their carrying amounts. For example **GPT** states:

"Deferred tax assets and liabilities are recognised for temporary differences at the tax rates expected to apply when the assets are recovered or liabilities are settled, based on those tax rates which are enacted or substantively enacted for each jurisdiction."

Castellum is most explicit about the fact that providing for deferred tax at nominal values for single asset entities economically seems not in line with the fact that recovery by means of sales of the shares often results in settlement of tax at lower rates than provided for:

"In the balance sheet the deferred tax liability is based on that all properties are sold today with worst possible taxation outcome, i.e. a direct sale. The effective tax is lower because of both the possibility to sell properties in a tax efficient manner, and the time factor that causes the tax to be discounted. At present, the actual discounted deferred tax liability is considered to be approx. 5%, giving a value of SEKm 537 million which is considerably lower than the SEKm 2,824 accounted for."

One company states that deferred tax on the revaluation surplus is calculated on the basis of the chargeable gains that would crystallise on the sale of the investment portfolio as at the reporting date. Another company did not disclose an accounting policy on deferred taxes at all.

These exceptions suggests that, as yet, there is some divergence in practice.



6 Debt covenant compliance

The continuing pressure on the financial and property markets during 2009 also impacted the loan disclosures in the financial statements. Generally, it is believed that the property sector is facing very significant refinancing issues due to breach of covenants and/ or poor quality of properties for a very substantial portion of real estate loans which are due to be refinanced in the next three years.

Paragraph 18 of IFRS 7 requires the following:

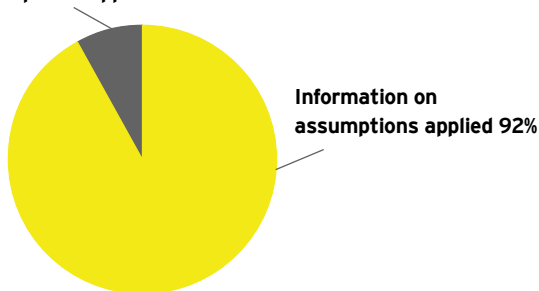
“For loans payable recognised at the end of the reporting period, an entity shall disclose:

- (a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
- (b) the carrying amount of the loans payable in default at the end of the reporting period; and
- (c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.”

Almost all companies (92%) have included information in the financial statements about actual covenants applicable and the situation as per balance sheet date. This is a significant increase compared with the information provided in previous years.

Information loan covenants

No information on assumptions applied 8%



In most cases, the loan covenants are disclosed in general.

GPT, however, was more specific and disclosed that no breaches were identified:

“GPT’s borrowings are subject to a range of covenants, according to the specific purpose and nature of the loans. Most facilities include one or more of the following covenants:

- ▶ A 40% maximum threshold limit on the percentage of GPT debt to total tangible assets
- ▶ A 55% maximum threshold limit on the percentage of GPT debt to total assets on a “look through” basis; and
- ▶ A minimum interest cover ratio of 2 times, being EBIT divide finance costs

A breach of these covenants for individual facilities may trigger consequences ranging from rectifying and/or repricing to repayment of outstanding amounts. The Group performed a review of debt covenants as at 31 December 2009 and no breaches were identified.”

Other companies disclosed specifically what the actual covenant ratios were at balance sheet date, for example, **Sponda** discloses:

“The most important covenants used are:

- ▶ Interest coverage ratio (EBITDA/Net interest cost) the acceptable minimum ratio of which is 1.75. The ratio on the closing date was 2.7
- ▶ Equity ratio, the determined minimum ratio of which is 28%. On the closing date the equity ratio stood at 37%”

We also reviewed whether the companies under survey included information sensitivity analyses with respect to the covenants. Three companies (9%) disclosed information on this in their directors’ report, none has included any sensitivity analyses in the financial statements.



7 Other Issues

7.1 Service charges

A principal question is whether property service charges should be presented gross or net. The general answer is that net presentation is required if the property company is acting as an agent.

As part of its Annual Improvements project the IASB, in April 2009, added guidance to the Appendix of IAS 18 to help determine whether an entity is acting as a principal or as an agent. Previously IFRS contained no guidance in making this determination. The Appendix to IAS 18 now starts by explaining that this is a subjective matter requiring consideration of all facts and circumstances and that an entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or rendering of services. This guidance then includes four criteria that, individually or in combination, indicate that an entity is acting as principal, as follows:

- ▶ The entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order, for example by being responsible for the acceptability of the products or services ordered or purchased by the customer
- ▶ The entity has inventory risk before or after the customer order, during shipping or on return
- ▶ The entity has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services
- ▶ The entity bears the customer's credit risk on the receivable due from the customer

Conversely, an indicator of an entity acting as agent exists when it does not have exposure to the significant risks and rewards associated with the sale of goods or rendering of services and this may be evidenced by the entity earning a predetermined amount, perhaps a fixed fee per transaction or a stated percentage of customer billings.

This year, we surveyed whether companies have disclosed their accounting policy around service charges and observed how service charges were presented.

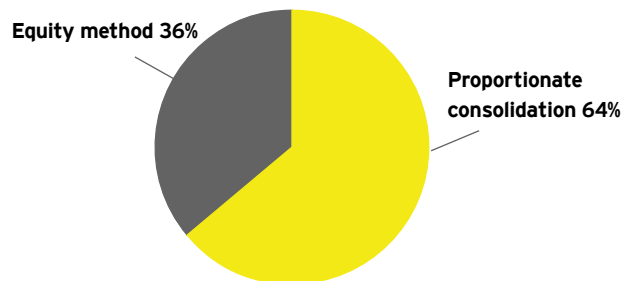
Sixteen companies (45%) reported service charges on a gross basis; they separately disclosed service income and expenses, either on the face of the income statement or in the notes thereto. Five companies showed the service charge income and the expenses gross on the face of the income statement. The majority of these companies (11), however, reported the service charge income and service charge expenses in the notes as part of the net rental income.

Only twelve companies (32%) disclosed their accounting policy relating to presentation of service charge income and expenses. For example, **Wereldhave** disclosed the following accounting policy:

"Services and operational costs are shown on a gross basis when the property owner acts as a principal. In case the property owner acts as an agent only the non recoverable amount of the service and operational costs are shown."

7.2 Joint venture accounting

Joint venture accounting



It is very common for property investors to enter in joint arrangements to facilitate investment in real estate assets. Twenty-four of the surveyed companies hold joint ventures. IAS 31 currently provides two options to account for joint ventures in the form of separate entities (jointly controlled entities), the first option is the equity method, and the other option is proportionate consolidation. Nine companies (38%) apply the equity method and sixteen (62%) apply the proportionate consolidation method. In the Exposure Draft *Joint Arrangements* issued by the IASB, proportionate consolidation is very much restricted to situations whereby the parties that have joint control over an arrangement have rights to the assets and obligations for the liabilities of the arrangement. In all other cases, proportionate consolidation would be replaced by equity accounting. This means that almost two thirds of companies may have to change their accounting policy, when the new standard will be adopted in its current form.

7.3 Operating segments

The new standard IFRS 8 *Operating Segments*, replaced IAS 14 *Segment Reporting* and became effective as of 1 January 2009 and applies to financial years starting on the same date. The standard covers the segmentation of companies' operations. According to the standard, a company will have the internal reporting structure as a starting point in deciding reportable segments. Eight companies in our survey explicitly reported that the change in accounting policy has not led to a change in the reported segments. The remainder were silent on the issue.

The number of segments reported ranged from two to nine segments. However, most companies recognised four or five segments. Most companies divided their segments based on property type (offices, retail, logistics or property development) and/or geographic criteria.

7.4 New accounting standards for 2010

The IASB and IFRIC have issued a number of standards and interpretations with an effective date after December 2009. The following standards might have an impact on real estate companies:

- ▶ IFRS 3 (revised) *Business Combinations* and IAS 27 (Amended) *Consolidated and Separate Financial Statements*
- ▶ IAS 7 *Leases* – amendment
- ▶ IAS 39 *Financial Instruments : Recognition and Measurement* – Eligible Hedged Items

A few companies mentioned that IFRS 3R might have an impact on the financial statements going forward, but also that the impact is not considered to be significant. As suggested in Section 4 *Definition of a business*, this may prove to be different. Other impacts of upcoming accounting standards were also considered not to have a material impact on the financial statements of the company.

8 Conclusion and looking ahead

There is an increasing demand for transparency in accounting and reporting standards. Last year, we concluded that there is only one answer to deal with valuation uncertainty: full transparency and disclosure of assumptions, valuation methods and estimates and meaningful sensitivity analysis. Again, as with last year, we noted improvements in this respect, but perhaps not as many as we had hoped. Other attention points are disclosures with respect to goodwill accounting, judgments applied in impairment testing and specifics on debt covenants compliance.

For 2010, it will be interesting to see how companies deal with IFRS3R and in particular with the ongoing discussions over the definition of a business combination: is a single tenanted property a business or an asset?

Companies also need to prepare for a host of new standards on financial statement presentation, joint arrangements, consolidation, revenue recognition, leasing and fair value measurement. Many require full retrospective application. The standards will have an enormous impact on financial statements, systems and business models. The IASB is currently seeking feedback on effective dates and transitional arrangements for these standards, and will then decide about a single date or staggered effective dates. However, it is clear that the upcoming years will be very busy preparing for the wave of new standards.

Nevertheless, Sir David Tweedy, Chairman of the IASB, said he has little sympathy for complaints on the surge of draft accounting standards being rolled out to meet the June 2011 US GAAP – IFRS convergence deadline. The November 30, 2010 progress report of the FASB and the IASB confirms a target completion date of June 2011 or earlier for the following priority projects:

- ▶ Joint projects on financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurement
- ▶ IASB projects on consolidation and insurance contracts.



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