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Do Croatian quoted companies satisfy IFRS disclosure requirements of accounting estimates for investment property?

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Abstract

Accounting estimates occur because a large number of items in financial statements cannot be measured precisely but can only be estimated. Significant accounting estimates are disclosed in the notes to the financial statements. The aim of the paper was to identify whether Croatian quoted companies disclose all information about accounting estimates related to the Investment property, as required by IAS 40. The research included 132 quoted companies in Croatia that apply IFRSs. The research results showed that investment property has a relatively small share in the structure of total assets of quoted companies in Croatia, which is probably one of the reasons why related accounting estimates published in the notes are brief and incomplete. The general conclusion is that the notes regarding accounting estimates on investment property are composed of definitions set in the standard, instead of providing more transparent information for investors and other interested users of financial statements. As expected, the companies with the higher share of investment property have shown greater level of transparency, providing additional information which is not required by the standards.

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1. Introduction

Accounting estimates, along with accounting policies, are very important in achieving comparable financial statements. If applied in accordance with generally accepted accounting principles, standards and procedures, they contribute to the quality of the disclosed information. Accounting estimates occur because a large number of items in financial statements cannot be measured precisely but can only be estimated. According to the IFRSs, accounting estimates are judgments based on the latest available reliable information. They represent an important part of financial statements and should not reduce the reliability of information about companies' financial health and efficiency. An entity has to disclose significant accounting estimates as well as the nature and amount of change in the accounting estimate that has an effect on the current period or which is expected to have an effect on the future periods. The aim of the paper is to identify whether Croatian quoted companies disclose all information about accounting estimates related to the recognition and measurement of Investment property, as required by the accounting standards (IAS 8 and IAS 40). The research includes 132 quoted companies in Croatia that apply IFRSs. The data source for the research is based on financial statements available on the website of Financial Agency, which is in charge of the publication of financial statements in Croatia. The first goal of the research is to identify the companies that publish the item Investment property in their balance sheets. The authors explore whether those companies disclose all the required information about accounting estimates of such assets in the notes to the financial statements. IAS 40 allows Investment property to be measured subsequently at cost or fair value. If a company applies a cost model, it is obligated to assess the useful life of Investment property and specify it in the notes to the financial statements, together with the fair value of the investment. If the fair value of an item Investment property cannot be measured reliably, the entity shall disclose an explanation for not estimating the fair value. If possible, the range of estimates within which fair value is highly likely to lie should be indicated. The notes to the financial statements of quoted companies in Croatia are analyzed according to the mentioned criteria. Descriptive statistics is used to organize the collected data. The research results point out that quoted companies in Croatia do not disclose all the required information about accounting estimates. Therefore, there is a plenty of room for further improvement of transparent financial reporting regarding accounting estimates. Thus, a positive impact on informing capital market participants about business performance of the quoted companies in Croatia would be established.

2. The role of accounting estimates in valuation of investment property

2.1. Investment property

Companies acquire properties from different reasons. From the accounting's point of view the purpose of the acquired asset is very important for the determination of accounting standards authority. The accounting treatment of a property which some company uses when performing its basic actitivies is within the competences of IAS 16 – Property, plant and equipment. However, a property which is held to earn rentals or for capital appreciation is regulated by IAS 40 – Investment property. It should be noted that in cases where the conditions for its sale are met in accordance with IFRS 5, the property can be classified as Non-current assets held for sale. This kind of assets should be classified as current assets in the balance sheet by the criteria of liquidity. Under the current IAS 40 "*Investment property is property (land or building, or part of a building, or both) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for: (a) use in the production or supply of goods or services or for administrative purposes, or (b) sale in the ordinary case of business.*" The standard clearly states that a property which is used in the normal course of business, covered by IAS 16, should be distinguished from the property obtained for the purpose of acquisition, generation of revenues from operating lease with no intention of its permanent disposal, or because of earnings due to capital appreciation. Property can also be classified as inventories (IAS 2 – Inventories) if intended for sale in the ordinary course of business. Therefore, it is expected from management to clearly define the intention of holding the property in order to choose and apply adequate accounting standard for the accounting treatment of the property.

An accounting standard that represents a sort of precursor to IAS 40 is IAS 25 – *Accounting for Investments*. This standard covered not only tangible assets but also financial assets. IAS 25 was issued in 1986 and abandoned in

2000 with the release of IAS 40. According to IAS 25 (IFRS 1991/1992 and Camifferman, Zeff, 2007), an investment was "*an asset held by an enterprise for the creation of wealth through distribution (such as interest, royalties, dividends and rentals*)" in order to make a profit and increase equity. Under IAS 25, an investment property could have been treated as property (IAS 16 – Property, plant and equipment) which has to be depreciated (former IAS 4 – Depreciation accounting) or as an investment (IAS 25) which should be subsequently measured at market value (revaluation).

Chronologically, the most significant change in the subsequent measurement of investment property compared to IAS 25 is the introduction of fair value model. IAS 40 has historically been the first standard that allowed the application of the fair value model for non-financial forms of assets, under which all changes in the market value of investment are recorded as unrealized gains or losses in the income statement. In addition, financial assets have been excluded from the scope of IAS 40. Since its initial issuance, IAS 40 has been revised and amended several times. Changes to IAS 40 in 2003 were mainly related to the conditions that operating leases must satisfy in order to meet the definition of investment property. The change in the standard which was important from the information point of view concerned the mandatory disclosure of fair value of investment proprety in case where a company used the cost model for subsequent measurement. The benefits of current IAS 40 compared to the original IAS 25 are related to significantly expanded disclosure requirements on investment property in the notes to the financial statements. As a result, all interested users of financial statements have more transparent information about the activities regarding investment proprety.

2.2. Initial recognition and subsequent measurement

The basic rules that must be met in order to recognize elements of financial statements (assets, liabilities and equity, revenues, expenses and financial result) are set out in the IFRS Conceptual Framework (IASB Conceptual Framework, 2010).

The Conceptual Framework for Financial Reporting is of particular significance as it "assists the International Accounting Standards Board (IASB) to develop standards that are based on consistent concepts; assists preparers to develop consistent accounting policies when no Standard applies to a particular transaction or event, or when a Standard allows a choice of accounting policy; and assists others to understand and interpret the standards" (IASB Conceptual Framework, 2015). Because of the importance and the problems identified eleven years ago, the first initiative for revision of the existing IFRS Framework was taken, and the Exposure draft of the IFRS Framework (Conceptual Framework for Financial Reporting) was finally released in 2015. The Exposure draft proposes, among other things, a new definition of assets: "An asset is a present economic resource controlled by the entity as a result of past events". The crucial part of the new definition refers to the fact that an economic resource is a right that has the potential to produce economic benefits for the entity. It appears that one of the reasons for changes in the definition of assets was to distinguish the assets from cash outflows (Mamic Sacer, 2015). The Framework does not represent an accounting standard, but it provides basic assumptions for initial recognition and subsequent measurements of the financial statements elements. Accounting standards (IASs and IFRSs) set more detail rules for recording business events and disclosing relevant accounting information.

Specific rules for the recognition and measurement of investment property are covered by IAS 40, which requires that an investment property is recognized as an asset when, and only when: (a) it is probable that the future economic benefits that are associated with the investment property will flow into the entity, and (b) the cost of the investment property can be measured reliably. When both conditions are cumulatively satisfied, an investment property is initially recognized at cost, which in addition to the purchase price includes any directly attributable expenditure (ie. transaction costs). The subsequent measurement of investment property belongs to the field of accounting policies, since the standard allows management to choose the cost model or the fair value model. It certainly has implications for the value of the item Investment property presented in the balance sheet. A survey conducted in 2010 on a sample of real estate companies from Finland, France, Germany, Greece, Italy, Spain and Sweden (which applies IFRSs for the first time) has shown that the basic reasons for choosing fair value model for subsequent measurement of investment properties are: (a) information asymmetry, (b) contractual efficiency, and (c) managerial opportunism (Quagli, Avallone, 2010). The accounting standard which originaly regulated investment property, IAS 25, distinguished between current and long-term investments, whose subsequent measurement in some segments differed in relation to the current IAS 40. Namely, long-term investments, according to IAS 25, could be measured at: cost, revalued amounts, or in the case of marketable equity securities the lower of cost and market value determined on a portfolio basis. Investments classified as current investments could be carried in the balance sheet at either: market value, or the lower of cost and market value. In case where current investments were subsequenty measured at market value, changes in the carrying amoung of investments were included in profit or directly to equity as a revaluation surplus. In accordance with the current IAS 40, the effect of changes in the fair value of investments in subsequent measurement are recognized as an integral part of the profit or loss in the period in which they occurred, without any possibility of crediting revaluation surplus as was the case with the IAS 25. If management chooses the cost model as a basis for subsequent measurement of investment propery, it should refer to the requirements of IAS 16 related to the application of this model. The standard also emphasizes the need to apply guidelines of IFRS 5, if the property meets the criteria of classification as held for sale.

Since if has been often emphasized that the fundamental objective of adopting the IFRSs at the international level is to achieve a greater degree of financial statements comparability (Flaida Emine Alves de, S., et. al., 2015), a survey was conducted on a sample of Brazilian and Portuguese quoted companies in the period 2010 – 2012. The aim was to investigate the extent to which the allowed alternatives for the subsequent measurement of investment property affect the comparability of financial statements. As a result, it was found that, despite the accounting alternatives allowed by IAS 40, there was a mean comparability between the accounting practices of the observed of firms , with decreasing trend of the index over the years.

2.3. Areas of accounting estimates

Due to the uncertainties that characterize almost every form of business, a number of items in the financial statements cannot be measured reliably, but can only be estimated, which requires estimates based on the latest available information. The most common forms of estimates are usually referred to bad debts, the useful lives of long-term tangible and intangible assets, warranty obligations etc. The accounting standard that defines general requirements related to accounting estimates is IAS 8 – *Accounting policies, changes in accounting estimates and errors*. According to the standard, changes in accounting estimates are defined as *"an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities."* (IAS 8). Changes in accounting estimates result from new information or new developments and therefore should not reduce the reliability of information presented to the financial statements' users. Such changes have no effect on past accounting periods, as it is the case with accounting policies, but only on current and future accounting periods. In accordance with IAS 8, the entity shall disclose changes in accounting estimates in the notes to the financial statements.

The determination of whether the property should be classified as an investment property sometimes requires estimation. A typical example of such estimation is the estimation of the accounting treatment i.e. competent accounting standard in case where a property is partly owner-occupied and partly used for the purpose of renting (for example, the first two floors of a building are owner-occupied, while the third floor is rented to a third party). In this case, assuming that each floor cannot be sold separately, the property can be classified as the investment property only when the insignificant part of the building is owner-occupied (IFRS, 2015. A Briefing for Chief Executives, Audit Committees&Boards of Directors). Since it is crucial to clearly distinguish between the intended usages of the property and to choose the appropriate standard for initial recognition and subsequent measurement, table 1 shows allowed methods for the accounting treatment of property held for various purposes. Furthermore, the table offers typical examples of the application of specific standards. The application of different standards influences the reported values in the financial statements and therefore information on the financial health and business performance of a company.

If an entity chooses the cost model for the subsequent measurement of investment property, the estimation of depreciation method and useful live of the asset, its residual value, the impairment of property should be done etc. (IFRS 2015, A Briefing for Chief Executives, Audit Committees & Boards of Directors). Sometimes it is difficult to distinguish the changes in accounting policy from the changes of accounting estimates. In such cases, the change is considered as a change in accounting estimate.

Table 1. Classification, initial recognition and subsequent measurement of property held for vaious purposes in accordance with IAS/IFRS (Sever, 2013)

Standard	Example	Measurement at recognition	Measurement after recognition
IAS 2 (Inventories)	*Apartments build by the company with the intention of selling.*	• cost of purchase • cost of production	• lower of cost and net realizable value
IAS 16 (Property, plan and equipment)	*Administration building or factory building.*	• cost of purchase • cost of production (IAS 2)	• cost – accumulated depreciation – accumulated impairment losses • revaluated amount less any subsequent accumulated depreciation and subsequent accumulated impairment losses
IAS 40 (Investment property))	*Apartments which a company acquired with the intention of renting during the season.*	• cost of purchase	• fair value + or – gain or loss in the income statements • cost of purchase (according to IAS 16)
IFRS 5 (Non-current assets held for sale and discontinued operations)	*Building in a city center which has been used for administrative purposes and for which the sales plan is initiated.*	• lower of its carrying amount and fair value less costs to sell	• at the lower of carrying amount and fair value less costs to sell; impairment loss based on the difference between the adjusted carrying amounts of the asset/disposal group and fair value less costs to sell

Lev and Sougiannis research findings on the usefulness of accounting estimates in forecasting cash flow and earnings (2009) show the urgent need for increased reliability in accounting estimates, particularly given that the FASB and IASB continue to increase the importance of accounting estimates by encouraging the application of the fair value model. The reliability of accounting estimates may be affected by the bias of management. The research has shown that only a minority of senior auditor (33%) attempt to identify bias in accounting estimates and that they do so only after being told that the estimation process is biased (Mauldin, Wolfe, 2014).

2.4. Notes as the source of information for decision-making process

Notes to the financial statements represent an important source of information where more detailed explanation of information presented in the balance sheet, profit and loss account and other basic financial statements can be found. Accounting standards precisely define the disclosure requirements. Notes do not have a standardized form, which is understandable given that each company has specific business operations. For example, the notes of financial institutions are usually devoted to a more detailed explanation of financial assets and liabilities. On the other hand, manufacturing companies will place greater emphasis on long-term tangible assets and inventories. Significant accounting policies applied by an entity, as well as critical accounting estimates that enable a better understanding of information presented in financial statements should be disclosed in the notes.

IAS 40 prescribes the set of information which should be disclosed in the notes depending on the selected and applied method for subsequent measurement of investment property (cost model or fair value model). The purpose of this research was to analyse the notes of quoted companies in Croatia in order to determine disclosed information on accounting estimates related to the investment property and to find out whether they satisfy standard's disclosure requests. The disclosure requests for accounting estimates in case of cost model prescribed by IAS 40 cover following areas: ''*(a) the useful lives of investment property, (b) estimated fair value, (c) when an entity cannot measure the fair value of the investment property reliably, it shall disclose (i) a description of the investment property, (ii) an explanation of why fair value cannot be measured reliably, and (iii) if possible, the range of estimates within which fair value is highly likely to lie.*'' Regardless of the applied model (cost or fair value) an entity should, among other things, disclose "*the extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment* *property being valuated. If there has been no such valuation, that fact shall be disclosed."(IAS 40)*. As it can be seen, notwithstanding the applied method, IAS 40 requires the disclosure of fair value of investment property in the notes to the financial statements. Israeli, (2015) has come to the conclusion that managers are opportunistic when choosing the fair value model. This result is based on the research of management decisions on the fair value application for investment property. Despite the recognized amount of fair value in the balance sheet and its disclosed amount in the notes which both share an equivalent measurement base and are equally relevant for making business decisions, the research has shown that investors weight disclosed information in the notes less important than the recognized amounts in the balance sheet.

3. Analysis of disclosed information on investment property's accounting estimates of quoted Croatian companies

The study was conducted on companies whose securities are quoted on the Zagreb Stock Exchange, with the exception of financial institutions which were excluded from the analysis due to their specific business operations. Since the financial statements for four companies were not available, the analysis included 132 companies and was based on the financial statements for the year 2013. Data was gathered from the website of the Zagreb Stock Exchange and the Financial Agency, which is responsible for the publication of annual financial statements in Croatia.

3.1. Designing the research model

The main research goal was to investigate if Croatian quoted companies satisfy IAS 40 disclosure requirements. First, those companies that are required to apply IAS 40 were identified. For the purpose of the study, the isolation of the companies that disclose the item investment property in their balance sheets was performed. Second, the proportion of investment property for those companies was calculated in order to determine the significance of this kind of asset in total assets of a company. So, investment property was expressed as a percentage of long-term assets and total assets. Descriptive statistics methods were applied to calculate mean values and the measures of dispersion. Since, there is a wide dispersion of investment property's share among the analysed companies; outliers (extremely high or extremely low values) were eliminated when calculating mean values in order to obtain more reliable results.

The notes to the financial statements of quoted companies were analysed according to the criteria based on the required disclosures related to the accounting estimates under IAS 40 *Investment property*. According to the standard, it is essential that a company disclose the method of subsequent measurement of investment property. If a company applies cost model, it shall assess and disclose useful life of assets, fair value or an explanation why fair value could not be determined. In addition, it was explored if companies provide additional information which is not required by standards. For instance, disclosed analytical structure of investment property might be useful to the users of financial statements when making business decisions.

Detailed disclosures of accounting estimates related to investment property are especially important for those companies that have a large share of that asset in their balance sheets. To test whether the companies with higher proportion of investment property provide more information on made accounting estimates, the companies were ranked according to the level of transparency. The maximum number of points is 5, with 4 point awarded if the company publishes all information required by IAS 40 and 1 point for additional disclosures in the form of analytical structure of investment property. The points were used as a variable in the correlation analysis in order to determine the strength of the relationship between the level of disclosures and the relative importance of investment property in the structure of total assets.

3.2. Research results

The analysis of companies' balance sheets showed that 44 out of 132 analysed companies publish investment property, which represents 33%. The mean absolute value of this type of asset amounted to 38 million HRK, or 13,23% of long-term assets and 9,34% of total assets expressed in relative values. Dispersion among companies is extremely high, as indicated by the coefficient of variation of more than 170% (Table 2).

Table 2. Measures of descriptive statistics for item Investment property

	Absolute value of investment property	Relative value of investment property as a % of long-term assets	Relative value of investment property as a % of total assets
Mean	38.144.837	13,23	9,34
Median	9.226.452	3,48	1,65
Standard Deviation	71.318.088	23,41	20,89
Range	415.043.600	97,33	97,04
Minimum	7.000	0,00	0,00
Maximum	415.050.600	97,34	97,04
Sum	1.678.372.809	582,20	410,75
Count	44	44	44
Coefficient Of Variation	186,97	176,91	223,79

Mean value is heavily influenced by extreme values or outliers. When eliminating extremely high absolute and relative values of investment property from the observation, the mean is significantly lower (18,7 million HRK, 3,73% of long-term assets and 2,56% of total assets), as well as the measures of dispersion, which provides more reliable results (Table 3).

Table 3. Measures of descriptive statistics for item Investment property – outliers excluded from the calculation

	Absolute value of investment property	Relative value of investment property as a % of long-term assets	Relative value of investment property as a % of total assets
Mean	18.692.489	3,73	2,56
Median	8.210.333	2,10	1,20
Standard Deviation	25.395.866,30	4,13	3,10
Range	91.916.538	14,18	10,97
Minimum	7.000	0,00	0,00
Maximum	91.923.538	14,19	10,97
Sum	729.007.056	134,24	97,32
Count	39	36	38
Coefficient Of Variation	135,86	110,75	121,19

Table 4. Methods of subsequent measurement of Investment property applied by analyzed companies

	Absolute value	Relative value
Fair value model	10	22,73%
Cost model	24	54,55%
N/A	9	20,45%
Notes not available	1	2,27%
TOTAL	44	100%

The measures of descriptive statistics showed that the item investment property has a relatively small share in the structure of assets of quoted companies in Croatia. As for the method of subsequent measurement, 34 companies published the applied method in the notes to the financial statements, where the majority of companies (24) use the cost model (Table 4). 20% of the analysed companies did not publish the method of subsequent measurement.

All companies that apply fair value model in subsequent measurement of investment property directly disclosed the applied method within disclosed significant accounting policies in the notes. On the other hand, only 18 out of 24 companies that apply cost model directly disclosed the method. The cost model applied for 6 companies is indirectly concluded from the content of other notes (Table 5).

Table 5. Position of the Investment property's subsequent measurement method disclosures in the notes for companies that use cost model

	Absolute value	Relative value
directly in accounting policies	16	66,67%
directly within the notes to the balance sheet	2	8,33%
indirectly within the notes to the balance sheet	6	25,00%
TOTAL	24	100%

In addition to the methods of subsequent measurement, the publication of additional accounting estimates, required in case of cost model application, was explored. The results show that 37,5% of companies disclose the estimated useful life of investment property, 12,5% indicated estimated fair value and 16,67% of the analysed companies provided explanation for not estimating the fair value (Table 6).

Table 6. The frequency of disclosing additional accounting estimates in case of companies that use cost model for subsequent measurement of Investment property

	Absolute value	Relative value
Estimated useful lives	9/24	37,50%
Estimated fair value	3/24	12,50%
Explanation for not estimating fair value	4/24	16,67%

To investigate if the companies with higher share of investment property in long-term and total assets provide more detailed information on accounting estimates in the notes, the companies were awarded with the points for each category of the required disclosures under IAS 40. The aim was to quantify the level of transparency in order to be able to perform correlation analysis. Moreover, additional disclosure in the form of analytical structure of investment property was also taken into account. Once the level of transparency related to the accounting estimates on investment property was quantified, Pearson and Spearman correlation coefficient were calculated. Variables are the assessed level of transparency on the one side and the share of investment property in long-term/total assets on the other side (Table 7).

Table 7. Correlation coefficients between the share of Investment property in balance sheet and the level of disclosures on accounting estimates in the notes

Correlation between the share of item Investment property in long-term assets and the estimated level of disclosures related to accounting estimates in the notes					
	R	t	p (two-tailed)	n	df
Pearson Correlation	0,39737	2,77	0,008326	43	41
Spearman Correlation	0,51198	3,82	0,000444	43	41
Correlation between the share of item Investment property in total assets and the estimated level of disclosures related to accounting estimates in the notes					
	R	t	p (two-tailed)	n	df
Pearson Correlation	0,4127	2,9	0,005955	43	41
Spearman Correlation	0,49387	3,64	0,000756	43	41

According to Pearson correlation coefficient, which evaluates the linear relationship between the variables, the relationship is weak, although technically positive. However, Spearman correlation coefficient indicates stronger connection. It has to be stressed that the Spearman correlation evaluates the monotonic relationship between two variables, where the variables tend to change together, but not necessarily at the constant rate. Therefore, it is based on the ranked value for each variable rather than the raw data. According to Spearman correlation coefficient, the relationship between the level of disclosures on accounting estimates regarding investment property and the share of investment property in the structure of company's assets is considered statistically significant and positive.

3.3. Discussion

The research results based on the financial statements of quoted companies in Croatia have shown that only one third of the analysed companies invest in property and that the relative significance of the item investment property in the structure of total assets is small. Relatively small proportion is probably one of the reasons why a significant number of companies do not fully comply with the requirements of IAS 40 regarding the publication of accounting estimates. Specifically, only 14 out of 44 observed companies that have disclosed the item investment property in the balance sheet, have properly disclosed all the requested accounting estimates in the notes to the financial statements.

Information about the accounting estimates of investment property usually appears on three different places of the notes to the financial statements: as a part of company's significant accounting policies, critical accounting estimates and the notes related to the balance sheet. Most companies present a separate note within the significant accounting policies, stating method of initial and subsequent measurement of investment property, together with estimated useful life if cost model is applied. In the area of critical accounting estimates and judgements only 4 companies directly mentioned the estimates related to investment property. Notes to the balance sheet contain a more detailed specification of the type of property, annual depreciation, estimated fair value etc. It was observed that the notes related to investment property, in case of certain number of companies; do not provide a lot of information that might be useful for decision-making. On the contrary, they are primarily composed of the definitions contained in the relevant accounting standard.

As expected, the notes of companies with higher share of investment property provide more detailed disclosures on accounting estimates. A positive sign is that certain companies present more information than required by standards.

4. Conclusion

A property which is held to earn rentals or for capital appreciation is regulated by IAS 40 – *Investment property*. IAS 40 allows investment property to be measured subsequently at cost or fair value. IAS 40 requires the disclosure of a number of information in the notes to the financial statements by specifying which information should be disclosed when applying the cost model and which in case of fair value model. The purpose of this research was to analyse the notes of quoted companies in Croatia in order to determine which information on accounting estimates related to investment property they publish. The criteria for conducting the analysis were disclosure requests by IAS 40.

The research results showed that investment property has a relatively small share in the structure of total assets of quoted companies in Croatia, which is probably one of the reasons why related accounting estimates published in the notes are brief and incomplete. The general conclusion is that the notes regarding accounting estimates on investment property are composed of definitions set in the standard, instead of providing more transparent information for investors and other interested users of financial statements. As expected, the companies with the higher share of investment property have shown greater level of transparency, providing additional information which is not required by the standards.

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