

Investment property (Lecture A804 – 11.07 minutes)

Investment property is dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 16 *Investment Property*. For micro-entities choosing to prepare their financial statements under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, Section 12 *Property, Plant and Equipment and Investment Property* is relevant.

To qualify for treatment as an investment property, a property must be able to meet the definition of such. FRS 102 defines an 'investment property' as:

*Property (land or a 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 course of **business**.*

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Generally, where a property provides a rental income stream for the business then the property will meet the definition of an investment property and will be accounted for under FRS 102, Section 16 at fair value through profit or loss. The definition also refers to '... land or a building, or part of a building, or both'. This means that land held for capital appreciation purposes is classed as investment property; so too are properties in the course of construction that are being developed as investment property.

The definition of Investment property under FRS 102 can cause ambiguities. The key question that should be asked is 'What is the property being used for?' The answer to this question will usually lead to the correct accounting treatment.

Example – Property acquired to be redeveloped and sold

Holmes Homes Ltd is a house builder and acquires a block of terraced houses on 1 September 2022 which it is planning to redevelop and sell at a profit. The finance director has treated these properties as investment property in the balance sheet.

The finance director is incorrect to treat these properties as investment property because they have been specifically acquired for redevelopment and subsequent sale. The finance director should reclassify these properties as inventory and account for them at the lower of cost and estimated selling price less costs to complete and sell (i.e. FRS 102, Section 13 *Inventories*).

Example – Property leased to another party

Harper Ltd leases one of its properties to a third party under a finance lease. The finance director has classified this property as an investment property.

This treatment is incorrect as a property leased to another party under a finance lease should be treated as a debtor.

Example – Purchase of land

Revere Ltd acquires a large area of land that it is planning to hold for several years until the value of it increases to an optimum level, at which point it will sell the land. The finance director has treated this land as investment property.

Land which is held for long-term capital appreciation would meet the definition of investment property and hence the finance director is correct to treat this land as such.

1.1 Mixed use property

Mixed use property can be problematic because this has to be separated between the portion of the property which is owner-occupied (to which FRS 102, Section 17 will apply) and the part of the property which is investment property (to which FRS 102, Section 16 will apply). This separation is carried out if the resulting portions could be sold separately or leased out separately under a finance lease.

If the fair value of the investment property component cannot be measured reliably, Section 16 requires the entire property to be accounted for as property, plant and equipment in accordance with Section 17.

1.2 Initial recognition

On initial recognition, an investment property is recognised at cost. Cost may comprise several elements and includes the initial purchase price plus all directly attributable costs, such as:

- Legal fees
- Property transfer taxes
- Estate agency fees

An important point to emphasise is that only costs which are **directly attributable** to the acquisition of the investment property are capitalised on initial recognition. The term 'directly attributable costs' is not defined in FRS 102 but should be regarded as those costs which would have been avoided had the entity not entered into the transaction.

Certain costs may relate to the property's subsequent use but are not directly attributable to the acquisition of the property, such as marketing costs to attract new tenants and operating costs which are incurred prior to the property reaching its target occupancy rate. These costs are written off to profit or loss as incurred.

Leased investment property

FRS 102, para 16.6 says that the initial cost of a property interest held under a lease which is classified as investment property is to be treated as a finance lease regardless of the fact that it might have otherwise been classified as an operating lease if the lease fell under the provisions of Section 20 *Leases*. This means that the asset is recognised at the *lower* of the fair value of the property and the present value of the minimum lease payments.

The term 'minimum lease payments' is defined as:

*The payments over the **lease term** that the lessee is or can be required to make, excluding **contingent rent**, costs for services and taxes to be paid by and reimbursed to the lessor, together with:*

- (a) *for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or*
- (b) *for a lessor, any **residual value** guaranteed to the lessor by:*
 - (i) *the lessee;*
 - (ii) *a party related to the lessee; or*
 - (iii) *a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.*

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*However, if the lessee has an option to purchase the **asset** at a price that is expected to be sufficiently lower than **fair value** at the date the option becomes exercisable for it to be reasonably certain, at the **inception of the lease**, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.*

When a property interest held under a lease is classified as an investment property, it is the leasehold interest element that is classified at fair value and not the property itself. Applying this concept correctly means that the financial statements will reflect the fair value of the leasehold interest and not the fair value of the investment property.

FRS 102, para 20.9 states that at the start of the lease, the lessee recognises its rights of use and obligations under a finance lease at amounts equal to the fair value of the leased asset or, if lower, the present value of the minimum lease payments which are determined at the start of the lease.

FRS 102, para 16.6 states that the asset is recognised at the lower of the fair value of the property and the present value of the minimum lease payments with an equivalent amount being recognised as a liability in accordance with paragraphs 20.9 and 20.10 of the standard.

It should also be noted that all initial direct costs attributable in negotiating and arranging a lease are included in the amount recognised as an asset (e.g. directly attributable legal fees).

1.3 Subsequent measurement

Investment property is required to be revalued to fair value at each balance sheet date (with the exception of some investments properties in a group context – see 3.7 below). Changes in fair value are taken to the profit and loss account and are usually recognised within operating profit.

FRS 102 does not require the use of an operating profit line on the face of the profit and loss account; although in practice, many of the reputable accounts production software systems are including an operating profit line for clarity. There are no restrictions on including additional line items on the face of the profit and loss account under FRS 102 if doing so allows a true and fair view to be given.

The term ‘fair value’ is defined as:

*The amount for which an **asset** could be exchanged, a **liability** settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm’s length transaction. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in the Appendix to Section 2 Concepts and Pervasive Principles shall be used in determining fair value.*

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Essentially, fair value is an exit price.

The use of fair values will invariably contain some element of judgement and estimation, particularly those which are carried out in-house. Auditors will have to devise specific audit procedures to corroborate the valuations because in-house valuations will often be harder to audit (mainly because they will not be independent valuations) than those which have been commissioned by a qualified external valuer.

It should be remembered that even where accounts are not audited, they must still be properly prepared in accordance with the relevant standards, so investment property will still need to be held at a fair value, where appropriate, under FRS 102. Obviously if there is no audit, there is no requirement to gather specific evidence to support the valuation, so it is less likely that directors will need to seek an external valuation.

As there are invariably elements of judgement and estimation involved in arriving at fair value of investment property, the provisions in FRS 102, para 8.6 (information about judgements) and 8.7 (information about key sources of estimation uncertainty) should be carefully considered. Where judgements and estimation uncertainty are considered material, information about significant judgements should be disclosed in the entity’s significant accounting policies or in the notes; whereas information about key sources of estimation uncertainty should be disclosed in the notes to the financial statements. In

practice, the two are often disclosed together within the accounting policies section of the notes, though care should be taken to ensure both aspects are fully covered.

The Appendix to Section 2 of FRS 102 which contains the fair value guidance sets out three 'levels' in a hierarchy when determining fair value as follows (although FRS 102 does not refer to 'Levels' (rather it refers to a 'methodology' in FRS 102, para 2A.1) but 'Levels' have been used below to articulate the issue):

- Level 1: The best evidence of fair value is a quoted price for an identical asset in an active market.
- Level 2: The next best evidence when quoted prices are unavailable are prices of recent transactions for identical assets, provided there has not been a significant change in economic circumstances, or a significant lapse of time since the transaction took place.
- Level 3: The use of valuation techniques.

Level 1 refers to an 'active market' which is defined as:

A market in which all of the following conditions exist:

- (a) the items traded in the market are homogeneous;*
- (b) willing buyers and sellers can normally be found at any time; and*
- (c) prices are available to the public.*

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In practice, there are no active markets for investment properties, as an active market requires the assets to be homogenous. Even flats in the same block will have differences, such as the floor or aspect in which it is situated, so though prices may be available it fails to meet the definition of an active market.

A Level 2 valuation may also be fairly rare, but in this case the recently sold asset can be similar, rather than identical, so a recent sale of a flat in a block, for example, may be sufficient to allow such a valuation.

In practice a Level 3 valuation methodology will most commonly be used. External valuations also tend to be carried out by professionally qualified valuers with experience in valuing the relevant investment property. Such valuations are usually performed using the *Appraisal and Valuation Manual* of the Royal Institution of Chartered Surveyors (the 'Red Book') and such valuations are permissible under UK and Ireland GAAP.

FRS 102, para 16.7 says that changes in the fair value of investment property at each reporting date are to be recognised in profit or loss – not other comprehensive income (i.e. through a revaluation reserve). This is because FRS 102, Section 16 uses the Fair Value Accounting Rules in company law and hence changes in fair value pass through the profit and loss account and are reported within the make-up of operating profit (i.e. through cost of sales or administrative expenses where a Format 1 profit and loss account is being used).

Example – Change in fair value of an investment property

Dexter Ltd has an investment property on its balance sheet which is measured at fair value through profit or loss. At the year end 31 October 2022, the property had increased in value by £35,000. The company's taxable profits are expected to be approximately £400,000 over the next few years.

The fair value gain is recorded as follows:

	£
Dr Investment property	35,000
Cr Fair value gain (profit and loss)	35,000
<i>Being fair value gain on investment property at year end</i>	

Deferred tax

FRS 102, para 29.16 states:

*Deferred tax relating to **investment property** that is measured at **fair value** in accordance with Section 16 Investment Property shall be measured using the tax rates and allowances that apply to the sale of the asset, except for investment property that has a limited **useful life** and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the property over time.*

FRS 102, para 29.16

Example – Deferred tax on investment property gain

Continuing with the example of Dexter Ltd above. Assume that the company is not planning on selling the investment property. The company is expected to make taxable profits of £400,000 (i.e. more than £250,000) hence will pay tax at 25%. The associated deferred tax consequence is £8,750 (£35,000 x 25%) and is recorded as follows:

	£
Dr Deferred tax expense (P&L)	8,750
Cr Deferred tax provision	8,750
<i>Being deferred tax on fair value gain</i>	

1.4 Impact on distributable profit

Where gains are concerned, there may be a net gain which increases a company's profits once deferred tax has been brought into account and this is where caution needs to be exercised.

Net gains on fair value fluctuations of investment property are **not** distributable to the shareholders. This is because profits must be realised to be distributable which in essence means that they have been converted into cash or can be readily converted into cash. There is no guarantee that an investment property can be sold at the drop of a hat and so any net gains recorded in the profit and loss will not be distributable. Therefore, in the examples of Dexter Ltd above, the net gain taken to profit and loss would be £26,250 (£35,000 less £8,750) and this is not distributable.

It is advisable to keep a record of the value of reserves which are not distributable to the shareholders, either in the accounting records or by way of ring-fencing them in a 'Non-distributable reserve'¹ within the equity section of the balance sheet, so that they cannot be inappropriately distributed to the shareholders (as the distribution will then be unlawful). There is nothing in company law which requires such non-distributable reserves to be ring-fenced by way of an additional component of equity, but it is an effective way of ensuring they are kept separate from those reserves which are distributable. In any event, it is important that fair value gains and losses on investment property pass through the profit and loss account and are not taken directly to reserves because this would be incorrect.

1.5 Subsequent expenditure on investment property

Properties will require regular maintenance and repair to keep them up to a certain required standard and investment properties will, in most cases, often require maintenance to ensure compliance with legislation (such as Health and Safety legislation). Certain costs may qualify for recognition as capital expenditure, such as new equipment or an extension to an existing investment property. However, most maintenance costs will be expensed to the profit and loss account.

Where costs qualify for capitalisation on the balance sheet the issue which arises is one of presentation, such as whether to present the costs and change in the investment property's fair value as two separate items, or whether to present both as one single item. In such cases, the reporting entity should ensure that its accounting policy is clear.

Routine costs of maintaining an investment property are expensed to the profit and loss account. Routine costs of repair would include items such as replacing items due to general wear and tear, repairing the costs of breakage of equipment (such as windows and doors) and replacement of minor consumables or parts.

The fair value exercise may recognise a reduction in value due to the deterioration of major parts or the overall condition of the property.

¹ It should be noted that firms regulated by ICAEW are advised not to call the reserve a 'Fair value reserve' as ICAEW view this as implying financial instruments and hedge accounting. ICAEW advise their member firms to call the reserve a 'Non-distributable reserve'.

The costs of replacement or redevelopment of major parts of an investment property can be capitalised, provided they are adequately disclosed as movements in the notes to the financial statements, otherwise they should be expensed as repairs and maintenance expenditure.

1.6 Transfers

The transfer of properties from one classification to another can have tax consequences, some of which may not be advantageous to the reporting entity, therefore management should be aware of these once a property meets, or ceases to meet, the definition of investment property or property, plant and equipment.

FRS 102, para 16.9 states that a transfer to, or from, investment property classification must only be carried out when the property first meets, or ceases to meet, the definition of investment property or if otherwise required by FRS 102. Care should be taken to ensure that any changes of use are identified each time accounts are prepared, so that the assets can be transferred to a different class if appropriate.

Where a property is subsequently reclassified from investment property to property, plant and equipment or inventory, because it ceases to meet the definition of investment property, FRS 102, para 16.9A states that the deemed cost for subsequent accounting as property, plant and equipment or inventory is fair value at the date of change in use. Where the investment property is reclassified to property, plant and equipment, it will effectively be carried at a revalued amount in the financial statements and hence the disclosure requirements in respect of revalued assets will apply (i.e. the comparable amount under the historical accounting rules). In addition, there should also be a separate revaluation reserve recognised.

Property which has previously been accounted for as property, plant and equipment under FRS 102, Section 17 can only be reclassified to investment property status once it meets the definition of investment property. FRS 102, Section 17 will apply up to the date of change in use to comply with paragraph 16.9B. Any difference between the carrying amount of the property at the date of change in use and its fair value is treated in the same way as a revaluation under Section 17.

Where a property previously accounted for as inventory under Section 13 becomes investment property, any difference between the fair value of the property at the date of change and its previous carrying amount is recognised in profit or loss.

1.7 Intra-group investment property

FRS 102, para 16.4A provides an accounting policy choice for group members to either account for such properties at fair value through profit or loss or transfer them to property, plant and equipment (Section 17) and apply the cost model contained in that section in the individual financial statements of the group member.

FRS 102, para 16.4B states that when only part of a property is rented out to another group member and the remainder of the property is used for other purposes (e.g. rented to an

external third party or owner-occupied), para 16.4A (i.e. the accounting policy choice) only applies to the component of that property which is rented out to the group entity.

The option to carry investment property at fair value or at cost **only relates to groups**. It is not an accounting policy choice for other investment property.