

1 Fair value measurement for properties (Lecture A665 - 11.18 minutes)

At the outset it is worth noting that this section will be irrelevant for micro-entities choosing to report under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* because such entities cannot use the fair value or alternative accounting rules and hence cannot use fair value or revalued amounts in the financial statements. (The only exception to this is for property, plant and equipment or investment property purchased by way of an exchange of assets where fair value is usually used to determine the amount to be capitalised).

There are two sections in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* which apply where fair value measurement for properties are concerned: Section 16 *Investment Property* and Section 17 *Property, Plant and Equipment*.

Under FRS 102 (March 2018), Section 16, all investment properties **must** be remeasured to fair value at each reporting date with changes in fair value being reported through profit and loss. There are no 'undue cost or effort' exemptions to fall back on anymore because these were removed during the FRC's triennial review. The only exception to this rule is where an investment property is rented out to another group member, in which case FRS 102 (March 2018), paras 16.4A and 16.4B provide an accounting policy choice to measure such properties under the cost model (cost less depreciation less impairment) or at fair value through profit or loss. Where the entity chooses to measure investment property rented to another group member under the cost model, it is no longer within scope of Section 16 and the provisions in Section 17 will apply.

Please note that FRS 102 (March 2018), paras 16.4A and 16.4B were introduced as part of the amendments arising from the FRC's triennial review and therefore apply for accounting periods commencing on or after 1 January 2019. Early adoption is permissible provided all of the amendments arising from the triennial review are applied at the same time (the accounting policy option to measure intra-group investment property under the cost model cannot be early adopted on its own).

1.1 Recap of what constitutes investment property

Investment property is defined 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**.'*

*FRS 102
Glossary
**investment
property***

The distinction between investment property and owner-occupied property is crucial because the accounting treatments in Section 16 and Section 17 are significantly different. Essentially, where a property earns rentals for a business then it will meet the definition of investment property and hence be accounted for under Section 16. Keep in mind that the definition includes 'land **or** a building **or part** of a building, **or** both'. Old UK GAAP at SSAP 19 *Accounting for investment properties* scoped out properties in the course of construction, whereas Section 16 includes them. Therefore, property which is being constructed or developed for future use as investment property would be within scope of Section 16. Also, take care with property which has originally been purchased for use in the business, but ends up being rented out or just kept for its investment potential. Such property must be treated as investment property from the point at which the change in use takes place.

Example – Land

Hackett Co Ltd owns some land which it is holding onto for at least five years as it is likely that the value of the land will increase considerably over this five-year period.

Land held for long-term capital appreciation would meet the definition of investment property and hence be accounted for under Section 16. Land held for short-term sale in the ordinary course of business would not meet the definition as Section 13 *Inventories* would apply instead.

1.2 Initial recognition

When a property meets the definition of investment property it is initially recognised at cost, being:

- purchase price plus directly attributable costs which may include:
 - legal fees;
 - stamp duty; and
 - brokerage fees.

If payment is deferred beyond normal credit terms, the initial cost of the investment property is the present value of all future payments. If the investment property is being self-constructed, the provisions in FRS 102, paras 17.10 to 17.14 will apply.

FRS 102, para 16.6 states that the initial cost of a property interest held under a lease and classified as an investment property is accounted for as a finance lease even if the lease would otherwise be classed as an operating lease if it was within the scope of Section 20 *Leases*. Therefore, the asset is recognised at the **lower** of the fair value of the property and the present value of the minimum lease payments with a corresponding finance lease creditor. Any premium paid is treated as part of the minimum lease payments and hence is included in the cost of the asset, but excluded from the liability.

1.3 Subsequent measurement

As noted above, at each reporting date the investment property must be remeasured to fair value with changes in fair value passing through profit or loss. Do not take any revaluation gains or losses directly to a revaluation reserve because this is not the correct accounting treatment.

Changes are recognised in profit and loss because the entity is applying the fair value accounting rules in the Companies Act 2006. In addition, deferred tax must also be brought into account.

Example – Revalued investment property

On 1 March 2019, Pickup Co Ltd acquired an investment property for £150,000 including all associated legal fees and stamp duty. The company has an accounting reference date of 31 December.

On 31 December 2019, the value of the investment property had increased to £30,000. The change in fair value is accounted for as follows:

Dr Investment property	£30,000
Cr Fair value adjustments (profit and loss)	£30,000

Being increase in fair value of investment property as at 31 December 2019

This gain must not be taken to a 'Revaluation reserve' as was the case under old UK GAAP because it **must** pass through the profit and loss account. Whilst FRS 102 does not recognise the concept of 'operating profit' most entities are continuing to use the operating profit line item on the face of the profit and loss account and such gains must be included within the calculation of operating profit (i.e. within cost of sales or administrative expenses as appropriate or in separate line item if sufficient material).

FRS 102, para 29.16 also requires deferred tax to be brought into account for such investment properties using the tax rates and allowances which will apply to the sale of the asset. If we assume that Pickup Co Ltd has no plans to sell the asset for the foreseeable future, then deferred tax is calculated using the tax rates and laws which have been enacted or substantively enacted by the balance sheet date, hence we can use 17% (indexation allowances may also be available depending on when the asset was purchased but have been ignored for the purpose of this example) as this will be the corporation tax rate which will apply for the corporation tax year starting 1 April 2020. Therefore, deferred tax is accounted for as follows:

Dr Tax expense (profit and loss)	£5,100
Cr Deferred tax provision	£5,100

Being deferred tax on the investment property fair value gain at 17%

It should be emphasised that because the change in fair value has been recognised in profit and loss, it is not presented within a revaluation reserve. The net gain of £24,900 (£30,000 less £5,100) is not distributable to the shareholders because it is not a realised gain. Therefore, Pickup Co Ltd could choose to transfer a portion of its profit and loss reserves (retained earnings) equal to the net cumulative fair value gain for presentation purposes to a separate reserve. They do not have to do this because there is nothing in company law which requires a separate component of equity for such non-distributable gains.

However, it should be noted that where such a reserve is used, ICAEW are advising member firms **not** to refer to it as a 'fair value reserve' because a fair value reserve could include gains which are distributable. Instead, ICAEW are advising that reserve be referred to as a 'Non-distributable reserve'. Regardless of what the reserve is called, the directors must bear in mind that it is not available for distribution.

1.4 Investment property within a group

As noted above, the FRC introduced an accounting policy option as part of their triennial review which allows investment property rented out to another group member to be measured using either the cost model in Section 17 or the fair value model in Section 16. It is likely that most groups will elect to use the cost model as this effectively restores the accounting treatment for such properties to that which was found in old UK GAAP. It also saves time carrying out a revaluation which will effectively be eliminated on consolidation. This accounting policy choice is contained in FRS 102 (March 2018), paras 16.4A and 16.4B. As the accounting policy choice formed part of the FRC's triennial review, it is applied for accounting periods commencing on or after 1 January 2019. Early adoption is permissible provided that all the amendments arising from the triennial review are applied at the same time.

Example – Investment property rented to another group member

Topco Limited has an investment property which it rents out to another group member. The company is preparing its financial statements to 31 March 2019 and wishes to apply the accounting policy option to measure the intra-group investment property under the cost model.

A transitional provision now exists in FRS 102, para 1.19(a) which allows the entity to:

- apply the transitional provision which allows an entity to take the fair value at the date of transition (in this case 1 April 2017) and use that as deemed cost going forward; or
- use the historical cost of the property and depreciate/impair the asset as if it had always been carried at cost.

The company wishes to take the fair value at the date of transition and use that as deemed cost. As a consequence, the investment property is not being carried on a cost basis and is instead being measured under the alternative accounting rules. Hence any fair value uplift existing at the date of transition must be transferred to a revaluation reserve.

The company must then restate the comparatives and account for the intra-group investment property under the cost model in accordance with Section 17 *Property, Plant and Equipment*.

In addition, the company will have to make the historical cost comparable disclosures to comply with Sch. 1 to *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410), para 34.

It should also be noted that as the company has early adopted the triennial review amendments, it must disclose that it has done so in accordance with FRS 102, para 1.18 (small companies reporting under Section 1A are encouraged to make such a disclosure).

1.5 Property, plant and equipment

The Glossary to FRS 102 defines 'property, plant and equipment' as:

'Tangible assets that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and*
- (b) are expected to be used during more than one accounting period.'*

FRS 102
Glossary
**property, plant
and equipment**

Property, plant and equipment are dealt with in FRS 102, Section 17. Section 17 allows tangible fixed assets to be measured using the revaluation model provided that all assets within that asset class are also revalued. An 'asset class' is a grouping of assets, e.g. plant and machinery, fixtures and fittings and land and buildings. All assets within the asset class must be revalued at the same time to stop companies from deliberately revaluing those assets which have appreciated in value and leaving out those assets which may have depreciated in value as this will distort the balance sheet position of the company.

1.6 Revaluation model for property, plant and equipment

When an asset is measured under the revaluation model, it is restated to its carrying amount at the date of the revaluation less any subsequent accumulated depreciation and impairment losses.

FRS 102, Section 17 is not as specific as old UK GAAP at FRS 15 *Tangible fixed assets* was in terms of the frequency of the revaluation. FRS 102, Section 16 states that an entity must carry out a revaluation exercise with **sufficient regularity** such as to ensure that the asset's carrying amount in the balance sheet does not differ materially from its fair value at the balance sheet date.

Gains on revaluation are generally recognised in other comprehensive income via the revaluation reserve. The exception to this would be where the gain reverses a previously recognised revaluation decrease **in respect of the same asset** which has been recognised in profit or loss. In such cases, the gain is taken to profit or loss to the extent of the previously recognised loss with any resulting excess being taken to the revaluation reserve (see 4.7 below regarding revaluation losses). (Note, you cannot offset gains and losses from one asset against another asset).

When an entity applies the revaluation model it is applying the alternative accounting rules in company law and hence must present a revaluation reserve in the balance sheet. In addition, deferred tax must also be brought into account.

Example – Revaluation increase

Phonic Co Ltd has a 30 September accounting reference date. On 1 October 2015 it acquired a freehold property for £200,000 which includes all directly attributable costs of acquiring the property. The directors wish to keep the balance sheet as healthy as possible and have decided to measure this property under the revaluation model. The building element of the cost is £100,000 and the company depreciates its freehold buildings on a 25-year straight line basis (or 4% on cost). (Land is not depreciated as it is assumed to have an indefinite life).

As at 30 September 2018, the carrying amount of the property is £188,000, calculated as follows:

	£
Cost price	200,000
Less three years depreciation ($£4,000^1 \times 3$)	<u>(12,000)</u>
Net book value at 30 September 2018	188,000

On 30 September 2019, the property was revalued to £225,600.

FRS 102 does not prescribe the exact accounting treatments for a revaluation adjustment hence there are two ways in which the revaluation can be adjusted for. Phonic Co could either uplift the net book value or it could increase the original cost through a revaluation and then eliminate the accumulated depreciation.

	Method 1	Method 2
Cost/revaluation		
Prior to revaluation	200,000	200,000
Revaluation adjustment	<u>40,000*</u>	<u>25,600</u>
Post revaluation	240,000	225,600
Accumulated depreciation		
Prior to revaluation	12,000	12,000
Revaluation adjustment	<u>2,400</u>	<u>(12,000)</u>
After revaluation	<u>14,400</u>	-
Revalued amount	<u>225,600</u>	<u>225,600</u>

*The property's value increases by 20% ($£225,600 - £188,000 / £188,000 \times 100$) hence there is an uplift of 20% on cost and 20% on depreciation.

Method 1 revaluation journals

	£	£
Dr PPE revaluation	40,000	
Cr Revaluation reserve		40,000

¹ $£100,000 \times 4\% = £4,000$ per annum

Being uplift to cost following revaluation

Dr Revaluation reserve	2,400	
Cr PPE revaluation depreciation		2,400

Being adjustment to depreciation following revaluation

Value of the revaluation reserve pre deferred tax is £37,600

Method 2 revaluation journals	£	£
Dr PPE revaluation	25,600	
Cr Revaluation reserve		25,600

Being uplift to cost following revaluation

Dr Accumulated depreciation	12,000	
Cr Revaluation reserve		12,000

Being reallocation of accumulated depreciation following revaluation

Value of the revaluation reserve pre deferred tax is £37,600

Deferred tax

Deferred tax will also have to be brought into account because the property is a non-monetary asset which has been revalued. Deferred tax is calculated using the tax rates and allowances which have been enacted or substantively enacted by the balance sheet date. Hence, if we assume a 17% rate for the calculation of deferred tax, it is recorded in the accounts as follows:

Dr Revaluation reserve (other comprehensive income)	£6,392
Cr Deferred tax provision (other comprehensive income)	£6,392

Being deferred tax on revaluation of property (£37,600 x 17%)

Balance sheet extracts of the company as at 30 September 2019 are shown below:

	2019	2018
	£	£
Tangible fixed assets		
Property, plant and equipment	<u>225,600</u>	<u>188,000</u>
Provisions for liabilities		
Deferred tax	<u>6,392</u>	-
Capital and reserves		
Ordinary share capital	100	100
Revaluation reserve ²	<u>31,208³</u>	-

² Company law requires the revaluation reserve to be presented separately in the balance sheet

³ £37,600 less deferred tax of £6,392

The company must also disclose the comparable amounts determined under the historical cost accounting rules to comply with the Companies Act 2006.

1.7 Revaluation losses

The above example dealt with the accounting for a revaluation gain. However, there can also be a revaluation loss. When an asset suffers a revaluation loss, the carrying amount of the asset is reduced and the corresponding debit is taken to the revaluation reserve to the extent of a surplus **in respect of that asset**. Again, it is important to bear in mind that you cannot offset the loss against gains of any other assets in that asset class. Once the surplus in the revaluation reserve in respect of that asset has been used up, any further loss is recognised in profit or loss. Don't forget to adjust the deferred tax as well for the effects of the loss.

In a subsequent reporting period, if the asset appreciates in value, the gain is recognised in profit or loss to the extent of the previously recognised loss. Any further gain is recognised in the revaluation reserve – again don't forget the deferred tax consequences.

Where the client has several assets within a class that are being measured under the revaluation model, it is always advisable to have a working paper (e.g. a spreadsheet) in place which keeps a track of the revaluation surpluses and associated deferred tax in respect of each asset. This should be reconciled to the revaluation reserve in the equity section of the balance sheet on a regular basis so that any errors or omissions are corrected on a timely basis.

1.8 Further guidance

The FRC have produced some helpful Staff Factsheets which can be obtained free of charge from their website (www.frc.org.uk). FRS 102 Factsheet 5 *Property: Fair Value Measurement* provides an overview of accounting for fair value adjustments for property (although it does not go into the deferred tax issues which this section of the course has done). The Factsheets themselves are not a substitute for reading the standard, but they are a helpful additional resource to help accountants understand the accounting treatments together with the areas of company law which apply.

1.9 Points to note from this section

Do ensure that you have a sound understanding of the technical requirements of FRS 102, Sections 16 and 17 – particularly the accounting treatment for investment property. It is surprising how many accountants are still unfamiliar with the basic accounting treatments for fair value gains and losses. In addition, keep in mind that if you have a client that has chosen FRS 105 as its financial reporting framework, fair values or revaluation amounts cannot be

used – all property will be measured using the cost model (cost less depreciation less impairment).

Do obtain a sound understanding of the revaluation rules, i.e. when to take the balance of a revaluation loss to the profit and loss account and also when to take a gain to the profit and loss account. Be sure to understand the deferred tax consequences also where revaluations of investment property and property, plant and equipment are concerned.