FRS 102 Financial Instruments
Factsheet 5

by Robert Kirk

In my previous article, in the March 2019 issue of Accountancy Plus, I examined the content of Factsheet 4 on the topic of Financial Instruments. In this issue I am reviewing the content of Factsheet 5 on Property; Fair Value Measurement.

The factsheet does not cover the initial recording of the costs that should be capitalized but essentially, for all types of property, these should include all those costs necessary to bring the asset to its location and normal operating condition. That can include not just the purchase price less any trade discount but also legal, construction, and even decommissioning costs which are incurred at the end of the asset's life if there is a legal or other constructive obligation to carry out that work.

Under FRS 102 the need to revalue property assets depends on their nature. For owner occupied property, plant and equipment there is a clear option whether a reporting entity wishes to revalue or not. However, since the March 2018 amendments, all investment properties rented out to parties external to the group must be revalued each year as well as owner occupied properties where the revaluation model has been adopted. The argument is that a fair value for such properties should always be readily accessible and thus the previous excuse of 'undue cost or effort' has been removed.

Property, plant and equipment – subsequent accounting

After initial recognition, property, plant and equipment (P,P & E) can be measured by either adopting the cost or the revaluation model.

However, if a reporting entity adopts the revaluation model it has to be applied to all items of P,P & E for the same class of asset.

When the revaluation model is adopted then, as long as the P,P & E's fair value can be measured reliably, the asset must be revalued. Although the valuation would normally be undertaken by professional valuers, if there is no market-based evidence of fair value e.g. specialized assets, then depreciated replacement cost can be adopted instead. The valuation must be its fair value at the date of revaluation less any subsequent accumulated depreciation and impairment losses.

FRS 102 requires the revaluations to be carried out with sufficient regularity so as to ensure that the carrying amount does not differ materially from the fair value at the reporting date.

Revaluation gains are recognised in the revaluation reserve or surplus which is recorded in equity. However, they do represent increases in wealth and so any gains should also be reported in other comprehensive income (OCI). The exception to this is where the gains reverse previous revaluation losses that were recognised in profit or loss. The reverse must be credited to profit and loss but only to the extent of losses written off after adjusting notional depreciation based on the cost model.

"In practice most companies have either never revalued or have ceased revaluing their owner-occupied properties"

Robert Kirk

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An example is provided below. The subsequent depreciation charge must always be based on the revalued amount and also on the remaining economic useful lives of the assets. The following example illustrates the accounting treatment where P,P & E is initially revalued downwards followed by a subsequent revaluation upwards.

Example Downward Revaluation of Factory building and subsequent reversal		
ABC Ltd purchased a factory building in 2016 for €800,000. The building was being depreciated on a straight line basis over a useful life of 50 years with no residual value. On 31 December 2017 the building was revalued to €600,000 and again on 31 December 2018 to €780,000		
Solution		
Dr Factory buildings	€800,000	
Cr Bank		€800,000
Being purchase of factory building in 2016		
Dr Depreciation (P&L)	€ 32,000	
Cr Accumulated depreciation factory building		€ 32,000
Being depreciation charge of € 16,000 per annum for two years 2016 and 2017 (€800,000 ÷ 50 years)		
Dr Impairment loss (P&L)	€168,000	
Cr Accumulated depreciation factory building		€168,000
Being impairment writedown from book value of € 768,000 to € 600,000 at 31 December 2017		
Dr Depreciation (P&L)	€12,500	
Cr Accumulated depreciation factory		€12,500
Being depreciation charge of € 12,500 (€ 600,000 ÷ 48 years) for 2018		
Dr Accumulated depreciation factory building	€212,500	
Cr Factory building		€212,500
Being the elimination of accumulated depreciation at date of revaluation		
Dr Factory building	€192,500	
Cr Revaluation surplus/reserve (OCI)		€28,000
Reversal of previous writedown (P&L)		€164,500
Being the reversal of previous impairment writedown		

Note: Previous impairment loss €68,000 – €3,500 depreciation adjustment = €164,500

Notional depreciation €16,000 if no impairment in 2018 less actual depreciation €12,500 = €3,500

Had the building been kept under the cost model it would now be recorded at cost €800,000 less three years depreciation of €48,000 = €752,000.

However, it is valued at €780,000 thus a surplus of €28,000 arises which should be kept in a separate revaluation surplus/reserve.

Investment properties

Factsheet 5 also covers the accounting treatment of investment properties. Essentially these are defined as properties that are rented out to earn a rental income or capital appreciation rather than being used in the reporting entity's own business or for sale.

FRS 102 was stronger than the full international accounting standard IAS 40 Investment Property in that instead of giving entities a choice between recording the assets at cost or revaluing them, it made it virtually compulsory to revalue as long as a reliable measure of the asset's value could be measured without undue cost or effort. If that could not be achieved then entities could revert back to the cost model until a reliable measure became available. The revaluation gain or loss, unlike ordinary property, must be reported in profit and loss for the period.

The March 2018 amendments to FRS 102 have now removed the ability to revert back to cost on the grounds that a reliable measure should always be available for investment property. The third paragraph in the 'live' example below will now have to be removed.

John Henderson (Holdings) Ltd

Notes to the financial statements for year ended 31 December 2017 (Extract from Accounting Policies)

Investment Property

Investment property is initially recorded at cost, which includes purchase price and any directly attributable expenditure.

Investment property is revalued to its fair value at each reporting date and any changes in fair value are recognized in profit or loss.

If a reliable measure of fair value is no longer available without undue cost or effect for an item of investment property, it shall be transferred to tangible assets and treated as such until it is expected that fair value will be reliably measurable on an on-going basis.

That original accounting treatment had led to a problem for group investment properties where clearly any revaluation gain or loss between the members of the same family would be artificial and would need to be removed as a consolidation adjustment. To avoid that problem, the March 2018 amendments also permit group investment properties to make a choice between the cost or the revaluation model. However, if the former is chosen, the entity must abide by the rules in Section 17 of FRS 102 which means that those properties effectively are treated as owner occupied adopting the cost model and thus will need to be depreciated over their useful lives and also reviewed for possible impairment.

A number of reporting entities having investment properties as part of their portfolio have already been applying the revaluation model in previous years for their group investment properties. In order to apply the new rules, they will not have to apply a prior period adjustment if they adopt the cost model from now on. Instead they can use their last valuation as their deemed cost on transition

Example
Group Investment property previously adopting fair value reporting now opting to switch to the cost model

DEF Ltd has an office building that was rented out to a subsidiary. DEF Ltd had revalued the property to its fair value of € 500,000 at 31 December 2017 and on 1 January 2018 (date of transition for 31 December 2018 year end) it decided to revert to the cost model. The cumulative fair value gains to 31 December 2017 were € 200,000.

Its fair value at 1 January 2018 becomes its deemed cost and the basis for future depreciation charges which will be based on the asset's remaining useful life.

Company law and FRS 102 disclosure requirements for revalued properties will apply to the property on an ongoing basis, including the need to disclose comparable amounts determined according to the historical cost accounting rules (in this case cost of € 300,000).

The Factsheet also covers the accounting treatment when an asset previously defined as an investment property is now treated as an owner-occupied property. Using the same facts as the example above except this illustrates a switch from investment to owner occupied property.

Example
Investment property transferred to owner occupied property

GHI Ltd has an office building that was rented out to an unrelated party. Its fair value at 31 December 2017 was € 500,000 and on 1 January 2018 it became owner-occupied. The cumulative fair value gains to 31 December 2017 were € 200,000.

Its fair value at 1 January 2018 becomes its deemed cost and the basis for future depreciation charges. Although the value of the property has not changed, accounting entries will be required to move the cumulative fair value gains from retained profits to a revaluation reserve because the property is now measured under the alternative accounting rules.

The change in reserves is recognised as follows:

Dr Profit & loss account (retained profits) €200,000
Cr Revaluation reserve €200,000

Company law and FRS 102 disclosure requirements for revalued properties will apply to the property on an ongoing basis, including the need to disclose comparable amounts determined according to the historical cost accounting rules (in this case cost of € 300,000).

This example assumes that GHI Ltd measures owner-occupied property under the cost model.

If GHI Ltd adopts the revaluation model (which must be applied consistently to the same class of asset) the property would be measured at fair value in future reporting periods less accumulated depreciation and impairment losses.

However, the above entries would still be required on transfer to property, plant and equipment as the property will be measured under the alternative accounting rules.

In both examples the deferred tax implications need to be considered. These are not covered in the factsheet but are important as the process of revaluation creates a temporary difference under the rules in Section 29 of FRS 102. In the first example deferred tax would have been charged to profit and loss in the years of revaluation and recorded as a deferred tax liability. That remains unchanged.

However, in the second example because the revaluation gain has now been transferred out of retained earnings so must the related deferred tax liability, so the entry must be to Dr Revaluation Reserves and Cr Retained earnings with the deferred tax created to date. There would be no change to the overall liability on the statement of financial position.

Conclusion

The Factsheet is quite narrow in its application since it only covers how to account for revaluation of property and does not cover other issues in any depth such as depreciation, impairments and disposals. In practice most companies have either never revalued or have ceased revaluing their owner-occupied properties so most of the issues affected by the latest changes will be around the accounting treatment of investment properties. It should also be pointed out that micro entities are not permitted, under FRS 105, to revalue any class of property. Micros will therefore have to reverse any previous revaluation as well as any deferred tax recorded as these are also not permitted by the standard. There are no transitional arrangements in place.