Accounting for Property – Classification is Key!

Article by Helen Fee, BSc, PgD, FCA, Examiner in Professional 2 Advanced Corporate Reporting

Introduction

Entities hold land and buildings for a variety of reasons and there are number of questions that need to be addressed before the entity can determine the appropriate accounting treatment. This article takes the reader through a number of questions in relation to a ‘property’, whilst bringing together all the relevant international accounting standards which may apply.

The accounting treatments discussed can, of course, be applied to other pieces of property, plant and equipment, not just land and buildings. However, for the purposes of this article, property can be taken to mean land and or buildings.

1. When Can an Entity Recognise A Property as an Asset in its Financial Statements?

For a property to be recognised as an asset in an entity’s financial statements, it must meet the definition of an asset, as defined in the Conceptual Framework for Financial Reporting 2011:

‘An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity’.

Recognition is the process of incorporating in the statement of financial position an item that meets the definition of an asset and satisfies the following criteria for recognition:

- It is probable that any future economic benefit associated with the item will flow to or from the entity; and
- The item's cost or value can be measured with reliability.

Based on these general criteria a property is only recognised as an asset in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the property has a cost or value that can be measured reliably.

A property leased by an entity under a finance lease (as defined in IAS 17 Leases) meets these recognition criteria and so will be recognised as an asset in the statement of financial position of the lessee. This is the case, even if legal ownership of the property has not passed to the lessee.

2. How Shall the Entity Classify the Property in its Financial Statements?

Assuming a property is to be recognised as an asset in the statement of financial position, the next question involves its classification. The entity needs to determine which standard applies to the entity's property, as there are a number of possible alternatives:

- IAS 16 Property, Plant and Equipment
The following questions will help determine the classification of each property and identify the appropriate international accounting standard:

<table>
<thead>
<tr>
<th></th>
<th>Question</th>
<th>Appropriate International Standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Is the property being held (or being constructed) for use in the production or supply of goods or services, for rental to others, or for administrative purposes?</td>
<td>IAS 16</td>
</tr>
<tr>
<td>2</td>
<td>Is the building owned by the entity (or held under a finance lease) and leased out under one or more operating leases?</td>
<td>IAS 40</td>
</tr>
<tr>
<td></td>
<td>Is the building vacant but held to be leased out under one or more operating leases?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Is the property being constructed by the entity for future use as investment property?</td>
<td>IAS 40</td>
</tr>
<tr>
<td>3</td>
<td>Is the property being held (or being constructed) for sale in the ordinary course of business?</td>
<td>IAS 2</td>
</tr>
<tr>
<td>4</td>
<td>Is the property classified as held for sale (outside the ordinary course of business)?</td>
<td>IFRS 5</td>
</tr>
<tr>
<td></td>
<td>- Will its carrying amount be recovered principally through a sale transaction rather than through continuing use?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Is the property available for immediate sale in its present condition subject only to terms that are usual and customary for the sale of such assets?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Is the sale highly probable?</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Is a portion of the property being held for investment purposes and another portion being held for use in the production or supply of goods or services or for administrative purposes?</td>
<td>Apply IAS 16 or 40 to relevant portion</td>
</tr>
<tr>
<td></td>
<td>Can the portions be sold separately (or leased separately under a finance lease)?</td>
<td>IAS 16</td>
</tr>
<tr>
<td></td>
<td>Where the portions cannot be sold separately, is the portion being held for use in the production or supply of goods or services or for administrative purposes significant?</td>
<td>IAS 40</td>
</tr>
<tr>
<td></td>
<td>Where the portions cannot be sold separately, is the portion being held for use in the production or supply of goods or services or for administrative purposes insignificant?</td>
<td>IAS 40</td>
</tr>
<tr>
<td>7</td>
<td>Is the property owned by the entity but being leased to another entity under a finance lease, or is the property being leased by the entity under an operating lease?</td>
<td>Not recognised as asset by entity</td>
</tr>
</tbody>
</table>

### 3. How Will the Entity Measure the Property in its Financial Statements?

Having determined the appropriate classification of a property, the next step involves the measurement of the property. Each standard provides specific guidance in this area. Measurement involves assigning monetary amounts at which the elements of the financial statements are to be recognised and reported. (Per the Conceptual Framework for Financial Reporting 2011)
**Owner-occupied Property (IAS 16)**

*Initial Measurement*

An owner-occupied property is initially measured at cost. Measurement of cost is normally straightforward as it is generally the price paid.

However, where an asset is self-constructed, the production cost will be ascertained by aggregating the price paid for material, labour and other inputs used in the construction.

Cost can include the purchase price (less trade discounts or rebates), import duties and other taxes (if not recoverable). Cost can also include costs directly attributable to bringing the asset to the location & condition necessary for it to be capable of operating in the manner intended by management. Such costs may include site preparation, construction, initial delivery & handling, installation, assembly, testing, and professional fees. The estimated costs of dismantling and removing the asset, and restoring the site are also included, where an obligation exists to do so.

In general, subsequent expenditure, such as maintenance, servicing, and repairs are not capitalised, but expensed in the period to which they relate. However, if subsequent expenditure satisfies the recognition criteria for property, plant and equipment, it can be capitalised separately and depreciated over its useful life. The carrying amount of any parts replaced should simultaneously be derecognised.

*Subsequent Measurement*

IAS 16 permits entities to adopt either the revaluation model or the cost model, with the entity applying the chosen model to all of its properties.

Where an entity chooses the **cost model**, it shall measure the property at its cost less any accumulated depreciation and any accumulated impairment losses.

Where an entity chooses the **revaluation model**, the property shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. The fair value of a property is the price at which it could be exchanged between knowledgeable, willing parties in an arm’s length transaction.

If the property’s carrying amount is increased as a result of revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same property previously recognised in profit or loss.

If the property’s carrying amount is decreased as a result of revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.
Investment Property (IAS 40)

Initial Measurement

An investment property shall be measured initially at cost, with transaction costs included in the initial measurement. The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure, e.g. professional fees for legal services, property taxes, and, other transaction costs.

When a property is self-constructed, the production cost will be ascertained in a similar manner to a self-constructed asset accounted for under IAS 16.

Subsequent Measurement

IAS 40 permits entities to adopt either the fair value model or the cost model, with the entity applying the chosen model to all of its properties.

Where an entity chooses the cost model, it shall measure the property in accordance with IAS 16’s requirements for that model.

Where an entity chooses the fair value model, the property shall be carried at fair value. The fair value of an investment property shall reflect market conditions at the end of the reporting period.

IAS 40 requires all entities to determine the fair value of investment property, for the purpose of measurement (if the entity uses the fair value model) or disclosure (if it uses the cost model).

A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises.

Inventory (IAS 2)

A property classified as inventory shall be measured at the lower of cost and net realisable value.

Cost shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the property to its present location and condition.

Costs of purchase may include the purchase price (less trade discounts and rebates), import duties and other taxes (if not recoverable), and transport and handling costs.

Costs of conversion may include any direct costs of construction (e.g. direct labour and materials), allocation of variable production overheads (e.g. indirect materials & labour) and also allocation of fixed production overheads (e.g. insurance, rental of plant).

Other costs incurred in bringing the inventories to their present location and condition may include the cost of designing the building for a specific customer.

Where a property is expected to be sold at less than cost, the item is valued at net realisable value. The expected loss is therefore recognised immediately rather than when the item is
sold. This may occur if the asset is damaged, obsolete or there has been a decline in selling prices.

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

**Property held for sale (IFRS 5)**

An entity shall measure a property classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

All non-current assets held for sale are categorised as a ‘current’ assets, as their sale is expected to be completed within one year. They are presented separately from other assets in the statement of financial position.

Immediately before the initial classification of the asset as held for sale, the carrying amount of the asset shall be written down to its recoverable amount.

4. **What Happens When the Entity Changes the Use of the Property?**

As the categorisation of a property determines its measurement in the financial statements, any change of use can result in a change in the measurement of the property’s value and potentially the recognition of a gain or loss. IAS 40 deals in detail with certain transfers to and from investment property. Such transfers should be made when, and only when, there is a change of use.

It advises that, where an entity has a policy of carrying investment properties at cost less depreciation (the cost model), properties are transferred to investment properties at the carrying amount under the previous standard. There are no arising revaluation gains or losses, and no changes are made to the cost of the property for measurement or disclosure purposes.

Where an entity has a policy of carrying its investment properties at fair value (the fair value model), the table below details the required accounting treatment on transfer:

<table>
<thead>
<tr>
<th>Previous Use</th>
<th>At Date to Transfer (Before Transfer)</th>
<th>New Use</th>
<th>At Date of Transfer (After Transfer)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Property</td>
<td>Determine fair value at date of transfer</td>
<td>Owner-occupied property</td>
<td>The fair value becomes the deemed cost for subsequent accounting under IAS 16</td>
</tr>
<tr>
<td>Investment Property</td>
<td>Determine fair value at date of transfer</td>
<td>Inventory</td>
<td>The fair value becomes the deemed cost for subsequent accounting under IAS 2</td>
</tr>
<tr>
<td>Owner-occupied property</td>
<td>Apply IAS 16 up to the date of transfer</td>
<td>Investment Property</td>
<td>The property is fair valued under IAS 40 and any resulting revaluation gain or loss (difference between fair value and the previous carrying amount) is accounted for as a revaluation surplus or deficit</td>
</tr>
<tr>
<td>Inventory</td>
<td>Apply IAS 2 up to date of transfer</td>
<td>Investment Property</td>
<td>The property is fair valued under IAS 40 and any resulting revaluation gain or loss (difference between fair value and the previous carrying amount) is</td>
</tr>
</tbody>
</table>
Other instances of a change of use, not specifically addressed by IAS 40, include the following:

<table>
<thead>
<tr>
<th>Previous Use</th>
<th>At Date to Transfer (Before Transfer)</th>
<th>New Use</th>
<th>At Date of Transfer (After Transfer)</th>
</tr>
</thead>
</table>
| Owner-occupied property | Apply IAS 16 up to the date of transfer  
Cost model – depreciate property up to date of transfer  
Revaluation model – revalue property at date of transfer | Non-current  
Asset Held for Sale | The property is measured at the lower of its carrying amount and fair value less costs to sell and any resulting impairment loss is recognised in profit or loss |
| Investment Property   | Apply IAS 40 up to date of transfer  
Cost model – depreciate property up to date of transfer  
Fair value model - determine fair value at date of transfer | Non-current  
Asset Held for Sale | The property is measured at the lower of its carrying amount and fair value less costs to sell and any resulting impairment loss is recognised in profit or loss |
| Inventory             | Apply IAS 2 up to date of transfer  
Property should be carried at the lower of cost and net realisable value | Owner-occupied property | The carrying amount becomes the deemed cost for subsequent accounting under IAS 16 |

**Conclusion**

In the preparation of financial statements, it is very important for preparers to ascertain the status and use of each property held by an entity at the end of each reporting period. This information is vital in determining the correct accounting treatment and thus contributing towards the reliability of financial statements.