property, plant and equipment, and tangible fixed assets – part 2

relevant to ACCA Qualification Papers F3 and F7

revaluation and derecognition

This is the second of two articles, and considers revaluation of property, plant and equipment (PPE) and its derecognition. The first article, published in the June/July 2007 issue of *student accountant*, considered the initial measurement and depreciation of PPE.

There are rather more differences between IAS 16, *Property, Plant and Equipment* (the international standard) and FRS 15, *Tangible Fixed Assets* (the UK standard) in relation to revaluation and derecognition compared to initial measurement and depreciation. For both topics addressed in this article, the international position is outlined first, and then compared to the UK position.

REVALUATION OF PPE – IAS 16 POSITION

General principles

IAS 16 allows entities the choice of two valuation models for PPE – the cost model or the revaluation model. Each model needs to be applied consistently to all PPE of the same 'class'. A class of assets is a grouping of assets that have a similar nature or function within the business. For example, properties would typically be one class of assets, and plant and equipment another. Additionally, if the revaluation model is chosen, the revaluations need to be kept up to date, although IAS 16 is not specific as to how often assets need to be revalued.

When the revaluation model is used, assets are carried at their fair value, defined as 'the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction'.

Revaluation gains

Revaluation gains are recognised in equity unless they reverse revaluation losses on the same asset that were previously recognised in the income statement. In these circumstances, the revaluation gain is recognised in the income statement. Revaluation changes the depreciable amount of an asset so subsequent depreciation charges are affected.

EXAMPLE 1

A property was purchased on 1 January 20X0 for $2m (estimated depreciable amount $1m – useful economic life 50 years). Annual depreciation of $20,000 was charged from 20X0 to 20X4 inclusive and on 1 January 20X5 the carrying value of the property was $1.9m. The property was revalued to $2.8m on 1 January 20X5 (estimated depreciable amount $1.35m – the estimated useful economic life was unchanged). Show the treatment of the revaluation surplus and compute the revised annual depreciation charge.

Solution

The revaluation surplus of $900,000 ($2.8m - $1.9m) is recognised in the statement of changes in equity by crediting a revaluation reserve. The depreciable amount of the property is now $1.35m and the remaining estimated useful economic life 45 years (50 years from 1 January 20X0). Therefore, the depreciation charge from 20X5 onwards would be $30,000 ($1.35m x 1/45).

A revaluation usually increases the annual depreciation charge in the income statement. In the above example, the annual increase is $10,000 ($30,000 - $20,000). IAS 16 allows (but does not require) entities to make a transfer of this 'excess depreciation' from the revaluation reserve directly to retained earnings.

Revaluation losses
Revaluation losses are recognised in the income statement. The only exception to this rule is where a revaluation surplus exists relating to a previous revaluation of that asset. To that extent, a revaluation loss can be recognised in equity.

EXAMPLE 2
The property referred to in **Example 1** was revalued on 31 December 20X6. Its fair value had fallen to $1.5m. Compute the revaluation loss and state how it should be treated in the financial statements.

Solution
The carrying value of the property at 31 December 20X6 would have been $2.74m ($2.8m - 2 x $30,000). This means that the revaluation deficit is $1.24m ($2.74m - $1.5m).

If the transfer of excess depreciation (see above) is not made, then the balance in the revaluation reserve relating to this asset is $900,000 (see **Example 1**). Therefore $900,000 is deducted from equity and $340,000 ($1.24m - $900,000) is charged to the income statement.

If the transfer of excess depreciation is made, then the balance on the revaluation reserve at 31 December 20X6 is $880,000 ($900,000 - 2 x $10,000). Therefore $880,000 is deducted from equity and $360,000 ($1.24m - $880,000) charged to the income statement.

REVALUATION OF PPE – FRS 15 POSITION
Although the basic position in FRS 15 is similar to that of IAS 16, there are differences:

- FRS 15 is more specific than IAS 16 regarding the frequency of valuations. FRS 15 states that, as a minimum, assets should be revalued every five years.
- Under FRS 15 the amount to which a fixed asset is revalued is different than under IAS 16. As far as properties are concerned (these probably being the class of fixed asset most likely to be carried at valuation) the basic valuation principle is value for existing use – not reflecting any development potential. Notional, directly attributable acquisition costs should also be included where material. However, specialised properties may need to be valued on the basis of depreciated replacement cost, since there may be no data on which to base an 'existing use' valuation. If properties are surplus to the entity's requirements, then they should be valued at open market value net of expected directly attributable selling costs.
- Revaluation losses that are caused by a clear consumption of economic benefits, for example physical damage to an asset, should be recognised in the profit and loss account. Such losses are recognised as an operating cost similar to depreciation.
- Other revaluation losses, for example the effect of a general fall in market values on a portfolio of properties, should be partly recognised in the statement of total recognised gains and losses. However, if the loss is such that the carrying amount of the asset falls below depreciated historical cost, then any further losses need to be recognised in the profit and loss account.

EXAMPLE 3
State how the answers to **Examples 1 and 2** would change if FRS 15 were applied rather than IAS 16.

Solution
The answer to **Example 1** would not change at all. For **Example 2**, if the revaluation loss was caused by a consumption of economic benefits, then the whole loss would be recognised in the profit and loss account. If the revaluation loss was caused by general factors, then it would be necessary to compute the depreciated historical cost of the property. This is the carrying value of the property at 31 December 20X6 if the first revaluation on 1 January 20X5 had not been carried out and would be $1.86m ($2m - 7 x $20,000). The actual carrying value of the property at 31 December 20X6 was $2.74m (see **Example 2**). Therefore, of the revaluation loss of $1.24m (see **Example 2**), $880,000 ($2.74m - $1.86m) is charged to the statement of total recognised gains and losses, and the balance of $360,000 ($1.24m - $880,000) charged to the profit and loss account.

DERECOGNITION OF PPE – THE IAS 16 POSITION
PPE should be derecognised (removed from PPE) either on disposal or when no future economic benefits are expected from the asset (in other words, it is effectively scrapped). A gain or loss on disposal is recognised as the difference between the disposal proceeds and the carrying value of the asset (using the cost or revaluation model) at the date of disposal. This net gain is included in the income statement – the sales proceeds should not be recognised as revenue.

Where assets are measured using the revaluation model, any remaining balance in the revaluation reserve relating to the asset disposed of is transferred directly to retained earnings. No recycling of this balance into the income statement is permitted.

DISPOSAL OF ASSETS – IFRS 5 POSITION
IFRS 5, *Non-current assets held for sale and discontinued operations* is another standard that deals with the disposal of non-current assets and discontinued operations. An item of PPE becomes subject to the provisions of IFRS 5 (rather than IAS 16) if it is classified as held for sale. This classification can either be made for a single asset (where the planned disposal of an individual and fairly substantial asset takes place) or for a group of assets (where the disposal of a business component takes place). This article considers the implications of disposing of a single asset.

IFRS 5 is only applied if the held for sale criteria are satisfied, and an asset is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continued use. For this to be the case, the asset must be available for immediate sale in its present condition and its sale must be highly probable. Therefore, This is the second of two articles, and considers revaluation of property, plant and equipment (PPE) and its derecognition. The first article, published in the June/July 2007 issue of *student accountant*, considered the initial measurement and depreciation of PPE.

an appropriate level of management must be committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan must have been initiated. The asset needs to be actively marketed at a reasonable price, and a successful sale should normally be expected within one year of the date of classification.

The types of asset that would typically satisfy the above criteria would be property, and very substantial items of plant and equipment. The normal disposal or scrapping of plant and equipment towards the end of its useful life would be subject to the provisions of IAS 16. When an asset is classified as held for sale, IFRS 5 requires that it be moved from its existing balance sheet presentation (non-current assets) to a new category of the balance sheet – 'non-current assets held for sale'. No further depreciation is charged as its carrying value will be recovered principally through sale rather than continuing use.

The existing carrying value of the asset is compared with its 'fair value less costs to sell' (effectively the selling price less selling costs). If fair value less costs to sell is below the current carrying value, then the asset is written down to fair value less costs to sell and an impairment loss recognised. When the asset is sold, any difference between the new carrying value and the net selling price is shown as a profit or loss on sale.

EXAMPLE 4

An asset has a carrying value of $600,000. It is classified as held for sale on 30 September 20X6. At that date its fair value less costs to sell is estimated at $550,000. The asset was sold for $555,000 on 30 November 20X6. The year end of the entity is 31 December 20X6.

1 How would the classification as held for sale, and subsequent disposal, be treated in the 20X6 financial statements?
2 How would the answer differ if the carrying value of the asset at 30 September 20X6 was $500,000, with all other figures remaining the same?

Solution

1 On 30 September 20X6, the asset would be written down to its fair value less costs to sell of $550,000 and an impairment loss of $50,000 recognised. It would be removed from non-current assets and presented in 'non-current assets held for sale'. On 30 November 20X6 a profit on sale of $5,000 would be recognised.
2 On 30 September 20X6 the asset would be transferred to non-current assets held for sale at its existing carrying value of $500,000. When the asset is sold on 30 November 20X6, a profit on sale of $55,000 would be recognised.

Where an asset is measured under the revaluation model then IFRS 5 requires that its revaluation must be updated immediately prior to being classified as held for sale. The effect of this treatment is that the selling costs will always be charged to the income statement at the date the asset is classified as held for sale.

EXAMPLE 5

An asset being classified as held for sale is currently carried under the revaluation model at $600,000. Its latest fair value is $700,000 and the estimated costs of selling the asset are $10,000. Show how this transaction would be recorded in the financial statements.

Solution

Immediately prior to being classified as held for sale, the asset would be revalued to its latest fair value of $700,000, with a credit of $100,000 to equity. The fair value less costs to sell of the asset is $690,000 ($700,000 - $10,000). On reclassification, the asset would be written down to this value (being lower than the updated revalued amount) and $10,000 charged to the income statement.

DERECOGNITION OF PPE – FRS 15 POSITION

The FRS 15 position is effectively identical to that of IAS 16 in as far as derecognition of PPE is covered by IAS 16. However, there is no UK standard equivalent to IFRS 5, although the UK Accounting Standards Board has issued an exposure draft that is very similar to IFRS 5. ■

Paul Robins is a lecturer at FTC Kaplan