Practical Workshop for NBU Staff and Bankers

# Revaluation of Fixed Assets, Investment Properties and Assets held for Sale

CFRR
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# Introduction and objectives of the session

- Fixed assets and property may fall under the scope of different IFRS standards.
- These standards tend to have broadly a similar approach but in some specific cases require different treatments and they can be use only in difference circumstances.
- We will in these sessions focus mainly on the revaluation of these assets.
- The revaluation of owner occupied property (IAS 16) can be revalued and may in some jurisdictions have an impact on own funds.

# Introduction and objectives of the session

- For property or other assets that are repossessed by the bank, in this case IFRS 5 will need to be applied and the accounting treatments and disclosure requirements will vary from IAS 16.
- For properties held for investment or rental reasons, IAS 40 should be applied.
- These 3 standards IAS 16, IAS 40 and IFRS 5 are not that different from each other.  Their overall approach are broadly similar. However, they should be used in specific circumstances and the disclosure requirements are also different.
- The prudential implications, depending on national regulations, will stem mainly from IAS 16 (in the case of revaluation) rather than IAS 40 or IFRS 5.

# IAS 16 Fixed Assets and Property

# Revaluation model

- Following initial recognition, an item in PPE may be carried at a revalued amount. If revaluation model is used then valuations should be carried out at regular intervals. IAS 16 para 3.
- Fair value is usually the market value and assessed by professionally qualified valuer.
- If an entity decides to use the revaluation model, then it should do so for the entire class of assets. It may not revalue individual assets.

# Classes of assets

- Land and buildings
- Machinery
- Fixture and Fittings
- Motor Vehicles
  - IAS 16 para 37

- An increase in value is recognised in OCI and accumulated under the heading of revaluation surplus. IAS 16 para 39.

# Revaluation model

- Downward valuation is recognised directly in profit or loss.
- But downward valuation must be in the OCI if it reverses any previous upward valuation. Any excess should then be recognised directly in the P&L. IAS 16 para 40.

# Depreciation and revalued asset

- Depreciation is still applicable to revalued assets.
- Depreciation is based on the revalued amount.

# Example: Disclosures in Financial Statements of Notes

- Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs (‘deemed cost’), less any impairment losses and depreciation calculated to write-off the assets over their estimated useful lives as follows:
- – freehold land is not depreciated;
- – freehold buildings are depreciated at the greater of 2% per annum on a straight-line basis or over their remaining useful lives; and
- – leasehold land and buildings are depreciated over the shorter of their unexpired terms of the leases or their remaining useful lives.
- Equipment, fixtures and fittings (including equipment on operating leases where HSBC is the lessor) are stated at cost less any impairment losses and depreciation, is calculated on a straight-line basis to write-off the assets over their useful lives, which run to a maximum of 35 years but are generally between 5 years and 20 years.
- Property, plant and equipment is subject to an impairment review if there are events or changes in circumstances which indicate that the carrying amount may not be recoverable.
- HSBC holds certain properties as investments to earn rentals or for capital appreciation, or both. Investment properties are included in the balance sheet at fair value with changes in fair value recognised in the income statement. Fair values are determined by independent professional valuers who apply recognised valuation techniques.

# Example

- Land revalued from $200,000 to $300,000.
- Profit for the year $350,000
- B/f Revaluation Surplus $75,000
- Retained Earnings at start of the year $120,000

# Double entries

- Dr PPE 100,000
  - Cr OCI 100,000

- Extract from SOCI

  - Profit for the year 350,000
  - OCI
  - Revaluation Gain from Land 100,000
  - TOTAL COMP INCOME 450,000

# DOUBLE ENTRIES

» Extract from SOFP

| | | |
|---|---|---|
| » PPE | | 300,000 |
| » Total | | 300,000 |

| | | |
|---|---|---|
| » Equity | | |
| » Retained Earnings | (120,000+350,000) | 470,000 |
| » Revaluation Surplus | (75,000+100,000) | 175,000 |
| » Total Equity | | 645,000 |

# Revaluation and depreciation charge

- Where an asset has been revalued, the deprecation charge is based on the revalued amount, less any residual value, from the date of revaluation. The whole of the depreciation charge is recognised in profit or loss via the SCI. None is recognised in other comprehensive income and consequently set against the revaluation surplus.
- However, IAS 16 permits, and it is considered best practice to make, a transfer between reserves, of the ‘excess’ depreciation arising as a result of the revaluation.
- The effect is that SCI shows the economic benefit consumed, but distributable profits are not affected by extra depreciation on revalued assets. The amount of transfer is actual depreciation charged less equivalent charge based on original historical cost of assets (Debit revaluation surplus, Credit retained earnings). The transfer is shown in the statement of changes in equity.

# Revaluation and depreciation charge

» An item of PPE was purchased for €900,000 on 1 January 2007. It is estimated to have a useful life of 10 years and is depreciated on a straight line basis. On 1 January 2009, the asset is revalued to €960,000. The useful life remains unchanged at ten years:

| | |
|---|---|
| » Actual depreciation for 2009 based on revalued amount (960,000/8) | 120,000 |
| » Depreciation for 2009 based on historical cost (900,000/10) | (90,000) |
| » Difference | 30,000 |

# Example

» In the SCI for 2009, a depreciation expense of €120,000 will be charged. A reserve transfer, which will be shown in the statement of changes in equity, may be undertaken as follows:

| | | | |
|---|---|---|---|
| Debit revaluation surplus | 30,000 | | |
| | | Credit retained earnings | 30,000 |

# Example

» The closing balance on the revaluation surplus on 31 December 2009 will therefore be as follows:

| | |
|---|---|
| Balance arising on revaluation (€960,000 - €720,000) | 240,000 |
| Transfer to retained earnings | (30,000) |
| Result | 210,000 |

# IAS 40 Investment Properties

- IAS 40 *Investment Property* applies to the accounting for property (land and/or buildings) held to earn rentals or for capital appreciation (or both). Investment properties are initially measured at cost and, with some exceptions. may be subsequently measured using a cost model or fair value model, with changes in the fair value under the fair value model being recognised in profit or loss.
- Examples of investment property: [IAS 40.8]
- land held for long-term capital appreciation
- land held for a currently undetermined future use
- building leased out under an operating lease
- vacant building held to be leased out under an operating lease
- property that is being constructed or developed for future use as investment property

# IAS 40 Measurement

» IAS 40 permits entities to choose between: [IAS 40.30]

» a fair value model,

» and a cost model.

» Where a property has previously been measured at fair value, it should continue to be measured at fair value until disposal, even if comparable market transactions become less frequent or market prices become less readily available. [IAS 40.55]

# Reclassification

- **Transfers to or from investment property classification**
- Transfers to, or from, investment property should only be made when there is a change in use, evidenced by one or more of the following: [IAS 40.57]
- commencement of owner-occupation (transfer from investment property to owner-occupied property)
- commencement of development with a view to sale (transfer from investment property to inventories)
- end of owner-occupation (transfer from owner-occupied property to investment property)
- commencement of an operating lease to another party (transfer from inventories to investment property)
- end of construction or development (transfer from property in the course of construction/development to investment property
- When an entity decides to sell an investment property without development, the property is not reclassified as inventory but is dealt with as investment property until it is derecognised. [IAS 40.58]

# IAS 40 Investment properties

» IAS 40 is applicable to property, which is acquired as an investment rather than for use, is not consumed in the entity's operations and does not have a useful life. Examples of investment properties provided in IAS 40 include: land held for long-term capital appreciation and buildings leased out under one or more operating leases. It should be noted that property being constructed or developed for third parties is covered by IAS 11 Construction Contracts and property leased under a finance lease is covered by IAS 17 Leases. If the property is owner-occupied then IAS 16 applies. Once it has been ascertained that the property is an investment property, IAS 40, similar to IAS 16, allows a choice of two models; the 'fair value model ' or the 'cost model'. If the fair value model is used then any gain or loss arising from a change in the fair value of the investment property must be recognised in the calculation of profit and loss in the SCI for the period in which it arises.

» **This is in contrast to the IAS 16 treatment of revaluation gains and losses discussed earlier, which requires revaluation gains to be excluded from profit. In addition, under the fair value model, no deprecation is charged on investment properties.**

# IFRS 5: Non-current Assets Held for Sale and Discontinued Operations

- » Key provisions of IFRS 5 relating to assets held for sale
- » Held-for-sale classification
- » In general, the following conditions must be met for an asset (or 'disposal group') to be classified as held for sale: [IFRS 5.6-8]
- » management is committed to a plan to sell
- » the asset is available for immediate sale
- » an active programme to locate a buyer is initiated
- » the sale is highly probable, within 12 months of classification as held for sale (subject to limited exceptions)
- » the asset is being actively marketed for sale at a sales price reasonable in relation to its fair value
- » actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn
- » The assets need to be disposed of through sale. Therefore, operations that are expected to be wound down or abandoned would not meet the definition

# Measurement

- The following principles apply:
- *At the time of classification as held for sale.* Immediately before the initial classification of the asset as held for sale, the carrying amount of the asset will be measured in accordance with applicable IFRSs. Resulting adjustments are also recognised in accordance with applicable IFRSs. [IFRS 5.18]
- *After classification as held for sale.* Non-current assets or disposal groups that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell (fair value less costs to distribute in the case of assets classified as held for distribution to owners). [IFRS 5.15-15A]

# Measurement

- *Impairment.* Impairment must be considered both at the time of classification as held for sale and subsequently:
- *At the time of classification as held for sale.* Immediately prior to classifying an asset or disposal group as held for sale, impairment is measured and recognised in accordance with the applicable IFRSs (generally: IAS 16 *Property, Plant and Equipment*, IAS 36 *Impairment of Assets*, IAS 38 *Intangible Assets*, and IAS 39 *Financial Instruments: Recognition and Measurement*/IFRS 9 *Financial Instruments*).
- **Any impairment loss is recognised in profit or loss unless the asset had been measured at revalued amount under IAS 16 or IAS 38, in which case the impairment is treated as a revaluation decrease.**

# Measurement

- *After classification as held for sale.* Calculate any impairment loss based on the difference between the adjusted carrying amounts of the asset/disposal group and fair value less costs to sell.
- Any impairment loss that arises by using the measurement principles in IFRS 5 must be recognised in profit or loss [IFRS 5.20], even for assets previously carried at revalued amounts. This is supported by IFRS 5 BC.47 and BC.48, which indicate the inconsistency with IAS 36.
- *No depreciation.* Non-current assets or disposal groups that are classified as held for sale are not depreciated. [IFRS 5.25]

# Conclusion

» IAS 16 is used mainly for owner-occupied buildings. The bank has the option to use cost or fair value. Using fair value may impact own funds. And there will be an increase in depreciation charges.

» IAS 40 is used when banks is holding the building for investment purposes or to collect rent only.

» IFRS 5 is used for repossessed buildings held for sale with conditions attached.

» In all of the above cases, impairment tests should be conducted by the bank on the value of these assets.

# Conclusion

- If in case there is impairment, the P&L will be affected as well as own funds.
- In Basel II and Basel III, there are no prudential adjustments when impairment occurs. So there is a direct and 1 to 1 negative impact on own funds.
- For some banks, the amounts involved in these cases may not be very significant and may not affect going concern but they can still be material and the impact on own funds should not be underestimated.

**Thank You**

**Question**