Think Ahead ACCA

Technical factsheet

Accounting for property valuations

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INTRODUCTION

Accounting for property valuations is an area that proves challenging to some preparers. For the purposes of this technical factsheet, property valuations will comprise:

- investment property valuations
- owner-occupied property valuations.

FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with investment property in Section 16, *Investment Property*. Property, plant and equipment are dealt with in Section 17, *Property, Plant and Equipment*.

FRS 105, *The Financial Reporting Standard applicable to the Micro-entities Regime* deals with investment property and property, plant and equipment in one section only, which is Section 12, *Property, Plant and Equipment and Investment Property*.

For preparers of financial statements under UK-adopted IFRS, IAS 40, *Investment Property* is relevant, with owner-occupied property being subject to IAS 16, *Property, Plant and Equipment*.

This technical factsheet outlines the accounting treatments for both types of property, including the relevant deferred tax consequences. Throughout the factsheet, we will highlight the key differences between the requirements of UK GAAP and IFRS Standards, so that users can ensure that the correct accounting treatment is applied depending on the requirements of the applicable financial reporting framework.

1. INVESTMENT PROPERTY

In order to qualify for treatment as an investment property, a property must meet the definition of such. 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**.'* [1]

[1] FRS 102, Glossary: **investment property**.

In practice, where a property provides a rental income stream for the business, the property will meet the definition of investment property and hence will be accounted for under the provisions of FRS 102, Section 16. The definition also refers to '…land or a building, or part of a building, or both'. This means that land held for capital appreciation purposes is classed as investment property; so, too, are properties in the course of construction that are being developed for use as investment property.

Preparers must also have regard to FRS 102, para 16.3, which states:

*'A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property using this section if, and only if, the property would otherwise meet the definition of an investment property and the lessee can measure the **fair value** of the property interest on an on-going basis. The Appendix to Section 2 Concepts and Pervasive Principles provides guidance on determining fair value. This classification alternative is available on a property-by-property basis.'* [2]

Property such as social housing is not accounted for under FRS 102, Section 16 but is dealt with under Section 17 instead. This is confirmed in FRS 102, para 16.3A, which states:

*'Property held primarily for the provision of social benefits, eg social housing held by a **public benefit entity**, shall not be classified as investment property and shall be accounted for as property, plant and equipment in accordance with Section 17 Property, Plant and Equipment.'* [3]

Example: property acquired to be redeveloped and sold

Heraklion Homes Co is a house builder and acquires a block of terraced houses on 1 April 2021, which it is planning to redevelop and sell at a profit. The company prepares its financial statements under FRS 102. The finance director has treated these properties as investment property in the balance sheet.

The finance director is incorrect to treat such properties as investment property because they have been specifically acquired for redevelopment and subsequent sale. The finance director should reclassify them as inventories, and account for them at the lower of cost and estimated selling price less costs to complete and sell to comply with the requirements of FRS 102, Section 13, *Inventories*.

Example: purchase of land

Sunnie Co acquires a large area of land that it is planning to hold for several years until the value of the land increases to an optimum level, at which point it will sell the land and realise its fair value. The finance director has treated this land as investment property.

Land that is held for long-term capital appreciation would meet the definition of investment property and hence the finance director is correct to treat this land as such.

[2] FRS 102, para 16.3.
[3] FRS 102, para 16.3A.

1.2 Mixed-use property

Mixed use property can be problematic because this must be separated between the portion of the property that is owner-occupied (to which FRS 102, Section 17 will apply) and the part of the property that is investment property (to which FRS 102, Section 16 will apply).

When the fair value of the investment property component cannot be measured reliably, the entire property is accounted for as property, plant and equipment in accordance with Section 17.

1.3 Initial recognition of investment property

On initial recognition, a property that meets the definition of investment property is recognised at cost. Cost may comprise several elements and includes the initial purchase price plus all directly attributable costs.

The term 'directly attributable costs' is not defined in accounting standards but is regarded as those costs that would otherwise have been avoided had the entity not acquired the investment property. For investment property, directly attributable costs would be those costs which directly relate to the acquisition of the property, such as:

- legal fees
- property transfer taxes (eg stamp duty land tax)
- estate agency fees.

An entity may incur certain costs that relate to the property's subsequent use but are not directly attributable costs. Typical examples include marketing costs to attract new tenants and operating costs that are incurred prior to the property reaching its target occupancy rate. These sorts of costs are not recognised within the cost of the investment property on initial recognition.

Example: costs incurred in drawing up a lease

Perpignan Properties Co holds a portfolio of houses in the north of England that are rented out to tenants. During the year, the company acquired a new property and the company incurred legal fees in negotiating and drawing up the operating lease[4] for the tenant.

FRS 102, para 20.27 states that a lessor (in this case, Perpignan Properties) shall add to the carrying amount of the leased asset (the investment property) any initial direct costs it incurs in negotiating and arranging an operating lease. Such costs will be recognised as an expense in profit or loss over the lease term on the same basis as the lease income.

1.3 Deferred payment

Where payment for an investment property is deferred beyond normal credit terms, FRS 102, para 16.5 requires the cost to be recognised at the present value of all future payments.

The issue with the term 'deferred beyond normal credit terms' is that such terms can be difficult to establish. Ordinarily, in the UK, normal credit terms can be anything from 30 to 60 days, or even longer. Where investment property is concerned, these may be in the course of construction and hence credit terms may be over a number of years.

[4] The distinction between an operating lease and a finance lease for lessees does not exist in IFRS 16, *Leases*. A lessee will generally recognise a right-of-use asset in a lease on the balance sheet under IFRS 16.

Example: construction of an investment property

Emery Co enters into a binding agreement to purchase a property that is going to be used to earn rentals and payment has been deferred for 18 months. The finance director is unsure how to initially recognise the cost of the property in the company's balance sheet under FRS 102.

FRS 102, para 16.5 states that where payment is deferred beyond normal credit terms, the cost is the present value of all future payments. However, if the finance director calculates that there is no material difference between the fair value and the present value of the future payments, the use of the transaction price plus directly attributable costs would be acceptable.

1.4 Leased investment property

FRS 102, para 16.6 states that the initial cost of a property interest held under a lease that is classified as investment property is to be treated as a finance lease, regardless of the fact that it may have otherwise been classified as an operating lease if the lease fell under the provisions of FRS 102, Section 20 *Leases*. This means that the asset is recognised at the lower of the fair value of the property and the present value of the minimum lease payments.

When a property interest held under a lease is classified as investment property, it is the leasehold interest element that is classified at fair value and not the property itself. This means that the financial statements will reflect the fair value of the leasehold interest and not the fair value of investment property.

FRS 102, para 20.9 states that at the start of the lease, the lessee recognises its right of use and obligations under a finance lease at amounts equal to the fair value of the leased asset or, if lower, the present value of the minimum lease payments that are determined at the start of the lease. FRS 102, para 16.6 states that the asset is recognised at the lower of the fair value of the property and the present value of the minimum lease payments with an equivalent amount being recognised as a liability in accordance with FRS 102, paras 20.9 and 20.10.

All initial directly attributable costs in negotiating and arranging the lease are included in the amount recognised as an asset (eg legal fees).

1.5 Subsequent measurement

FRS 102, Section 16 applies the Fair Value Accounting Rules in company law, and all investment property (with the exception of intra-group investment property, which is examined below) must be remeasured to fair value at each reporting date. Changes in fair value are taken to profit or loss, and are usually recognised within operating profit[5].

ACCA comment

IAS 40 offers an accounting policy choice of using either the cost model (cost less depreciation less impairment) or the fair value model. However, IAS 40 does require companies that adopt the cost model to measure investment property to disclose the property's fair value as well. Hence, a fair value of the property will have to be obtained in any event for disclosure purposes.

[5] FRS 102 does not require the use of an operating profit line item on the face of the profit and loss account, although, in practice, many accounts production software systems do include such a line. There are no restrictions on including additional line items on the face of the profit and loss account under FRS 102 if doing so enables a true and fair view to be presented.

The Appendix to FRS 102, Section 2, *Concepts and Pervasive Principles* contains the fair value guidance, which is essentially split into three levels. FRS 102 does not use the term 'levels' but the term has been used to articulate the issue as follows:

Level 1: the best evidence of fair value is a quoted price for an identical asset in an active market

Level 2: the next best evidence when quoted prices are unavailable are prices of recent transactions for identical assets, provided there has not been a significant change in economic circumstances, or a significant lapse of time since the transaction took place

Level 3: the use of valuation techniques.

Level 1 refers to an 'active market'. An active market is defined as:

'A market in which all of the following conditions exist:

(a) the items traded in the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.' [6]

In practice, there are no active markets for investment properties, as an active market requires the asset to be homogenous. Even apartments within the same apartment block will be different (such as the floor on which it is situated), so although prices may be available, it fails to meet the definition of an active market.

A level 2 valuation may also be rare, but in this case the recently sold asset can be similar, rather than identical, so a recent sale of an apartment in a block, for example, may be sufficient to allow such a valuation.

A level 3 valuation methodology will be the most appropriate for an investment property. External valuations tend to be carried out by professionally qualified valuers with experience in valuing the investment property.

1.5.1 Accounting for a change in fair value

Changes in fair value of investment property are recorded in profit or loss. This is because FRS 102, Section 16 uses the Fair Value Accounting Rules in company law.

Example: change in fair value of an investment property

Westhead Co has an investment property on its balance sheet, which is measured under FRS 102, Section 16. At the year-end 31 December 2021, the property had increased in value from the prior year by £35,000. The company has been making annual profits amounting to approximately £500,000 per annum for the past five years and the company's forecasts indicate that this level of profit will continue for the foreseeable future.
The fair value gain will be recorded in Westhead Co's profit and loss account as follows:

[6] FRS 102, Glossary: **active market**.

	£
Dr Investment property	35,000
Cr Fair value gain (profit or loss)	35,000

Being fair value gain on investment property as at 31 December 2021

1.5.2 Deferred tax

FRS 102, para 29.16 states:

*'Deferred tax related to **investment property** that is measured at **fair value** in accordance with Section 16 Investment Property shall be measured using the tax rates and allowances that apply to sale of the asset, except for investment property that has a limited **useful life** and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the property over time.'* [7]

Investment property is a non-monetary asset that is subject to revaluation and hence falls under the scope of deferred tax in FRS 102, Section 29.

In the spring 2021 Budget, the chancellor announced that the rate of corporation tax would increase from 19% to 25% on 1 April 2023 for companies making taxable profits in excess of £250,000. However, the rate will remain at 19% for companies making taxable profits of £50,000 or less.

There is an added complexity at the present time for preparers of financial statements under UK GAAP because of this increase. FRS 102, Section 29, *Income Tax* requires deferred tax to be calculated using the tax rates and laws that have been enacted *or substantively enacted* by the reporting date and which are *expected to apply to the reversal of the timing difference*.

The 25% tax rate was codified in Finance (No. 2) Bill, which became substantively enacted on 24 May 2021. Consequently, for balance sheet dates ending on or after 24 May 2021, deferred tax in respect of timing differences that are expected to reverse on or after 1 April 2023 will need to be remeasured at 25% where taxable profits are expected to exceed £250,000, or at the marginal rate if taxable profits are expected to fall between £50,000 and £250,000.

Example: deferred tax on fair value gain

Continuing with the example of Westhead Co above, the fair value gain was £35,000 and the company expects to make profits around £500,000, hence will be taxed at 25% from 1 April 2023, even though profits will be taxed at 19% in the tax computation for the year ended 31 December 2021.

The financial year ended on 31 December 2021, and so deferred tax is calculated at a rate of 25% because this rate had been *substantively enacted* by the balance sheet date and is the rate that is expected to apply to the reversal of the timing difference. Consequently, a deferred tax liability on the fair value gain of £8,750 (£35,000 x 25%) arises and will be recorded as:

	£
Dr Deferred tax expense (P&L)	8,750
Cr Deferred tax provision	8,750

Being deferred tax on investment property fair value gain

[7] FRS 102, para 29.16.

1.5.3 Impact on distributable profit

The accounting treatment under FRS 102 means that the profit and loss account will take fair value gains and the associated deferred tax consequences.

Net gains on fair value fluctuations of investment property are **not** distributable to the shareholders. This is because profits must be 'realised' in order to be classed as distributable, which, in essence, means that they have been converted into cash or can be readily converted into known amounts of cash. There is no guarantee that an investment property can be sold instantly and so any net gains recorded in profit or loss will be classed as non-distributable. Hence, in the example of Westhead Co above, the net gain of £26,250 (£35,000-£8,750) is non-distributable.

It may be advisable to keep a record of the value of reserves that are not distributable to the shareholders either within the accounting records themselves or by ring-fencing them in a 'non-distributable reserve' within equity. There is nothing in company law that requires non-distributable profits to be ring-fenced in a separate component of equity, but it is an efficient means of keeping track of profits that cannot be distributed to the shareholders.

1.6 Investment property under FRS 105

As noted earlier, FRS 105 prohibits application of the Fair Value Accounting Rules in company law. All assets must be measured under the historical cost convention. Consequently, investment property is measured at cost less depreciation less accumulated impairment losses under FRS 105.

If the micro-entity wishes to measure its investment property at fair value, it must use FRS 102 (including the presentation and disclosure requirements of Section 1A, *Small Entities* if it wishes).

2. REVALUATIONS OF OWNER-OCCUPIED PROPERTY

Owner-occupied property (eg a freehold building) is measured under the provisions of FRS 102, Section 17, *Property, Plant and Equipment* or FRS 105, Section 12, *Property, Plant and Equipment and Investment Property*.

At initial recognition, the property is measured at cost. FRS 102, para 17.10 states that the cost of an item of property, plant and equipment (PPE) comprises all of the following:

'(a) Its purchase price, including legal and brokerage fees, import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. These can include the costs of site preparation, initial delivery and handling, installation and assembly, and testing of functionality.

(c) The initial estimate of the costs, recognised and measured in accordance with Section 21 Provisions and Contingencies, of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

(d) Any ***borrowing costs*** *capitalised in accordance with paragraph 25.2.'*[8]

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[8] FRS 102, para 17.10 (a) to (c).

ACCA comment

While FRS 102, Section 25, *Borrowing Costs* provides an accounting policy choice for an entity to either capitalise borrowing costs as part of the cost of an asset or write them off as incurred, IAS 23, *Borrowing Costs*, para 8 mandates the capitalisation of such costs if they are directly attributable to the acquisition, construction or production of a qualifying asset.

FRS 102, para 17.11 prohibits the capitalisation of the following costs, all of which must be written off to profit or loss as incurred:

'(a) *costs of opening a new facility;*

(b) costs of introducing a new product or service (including costs of advertising and promotional activities);

(c) costs of conducting ***business*** *in a new location or with a new class of customer (including costs of staff training); and*

(d) administration and other general overhead costs.'[9]

2.1 Subsequent measurement

After initial recognition at cost, there are two possible subsequent measurement bases available under FRS 102:

- cost model
- revaluation model.

For micro-entities applying FRS 105, only the cost model is permitted.

2.1.1 Cost model

Under the cost model, an entity measures an item of PPE at cost less depreciation less accumulated impairment losses.

Under the cost model, the gross cost of the asset will usually remain unchanged until it is derecognised; but net book value is reduced by the value of depreciation and applicable impairment.

2.1.2 Revaluation model

FRS 102, para 17.15B states that under the revaluation model, an item of PPE whose fair value can be measured reliably is carried at a revaluation amount, being its fair value at the date of revaluation, less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

It must be emphasised that **all** assets within the same asset class must be subject to revaluation.

FRS 102 defines 'class of assets' as:

[9] FRS 102, para 17.11 (a) to (c).

*‘A grouping of **assets** of a similar nature and use in an entity’s operations’.* [10]

For example, if an entity has four properties, then all four must be subject to the revaluation model; the entity cannot just ‘cherry pick’ those assets that have appreciated in value and ignore the others.

The revaluation exercise must be made with **sufficient regularity** to ensure that the carrying amount of the revalued asset at the reporting date does not differ materially from that which would be determined using fair value at the reporting date. It should also be borne in mind that once an entity selects the revaluation model as a subsequent measurement basis, it cannot go back to the cost model at a subsequent date.

This is because a change from the cost model to the revaluation model is a change in accounting policy. An entity can only voluntarily change an accounting policy when the change results in the financial statements providing reliable and more relevant information (FRS 102, para 10.8(b)). A switch back from the revaluation model to the cost model would not result in the financial statements providing reliable and more relevant information, as historical cost is less reliable than the revaluation model which uses fair value.

The revaluation model in FRS 102, Section 17 applies the Alternative Accounting Rules in company law. This means that any gains on revaluation are taken to a revaluation reserve in the equity section of the entity’s balance sheet and are reported as other comprehensive income. The Alternative Accounting Rules also require disclosure of the equivalent historical cost figures had the revaluation not taken place.

The statutory formats of the balance sheet require the revaluation reserve to be disclosed below ‘Share premium account’. Prior to the amendments to company law through *The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015* (SI 2015/980), the revaluation reserve did not have to be called that. However, SI 2015/980 removed this flexibility by deleting the words *‘…but need not be shown under that name’* in *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410), Sch 1, para 35(2). The equivalent for small companies and groups can be found in *The Small Companies and Groups (Accounts and Directors’ Report) Regulations 2008* (SI 2008/409), Sch 1, para 35(2).

The consequence of the above is that the revaluation reserve must no longer be referred to by another name in the statutory balance sheet.

2.2 Reporting revaluation gains and losses

When an asset’s carrying amount is increased as a result of a revaluation gain, the increase is recognised in other comprehensive income within the revaluation reserve (ie accumulated within equity). The exception to this rule is to the extent that a revaluation gain reverses a previous revaluation decrease of the same asset that had been recognised in profit or loss.

Decreases arising as a result of a revaluation loss must be recognised in other comprehensive income (via the revaluation reserve) to the extent that a credit balance exists on the revaluation reserve in respect of that asset. Any excess loss is then reported in profit or loss. An entity cannot have a debit balance on a revaluation reserve in respect of any asset measured under the revaluation model.

[10] FRS 102, Glossary: **class of assets**.

Example: revaluation gains and losses

Dexter Co has an asset with a carrying value of £40,000. On 1 August 2020, the asset was revalued upwards to £60,000 (note deferred tax implications are ignored for the purposes of this example). The entries in the books to reflect this revaluation gain are:

	£
Dr PPE revaluation	20,000
Cr Revaluation reserve	20,000
Being revaluation gain on asset at 1 August 2020	

On 31 July 2021, the asset's value had decreased to £30,000. The entries in the books to reflect this revaluation loss are:

	£
Dr Revaluation reserve	20,000
Dr Profit and loss account	10,000
Cr PPE	30,000
Being revaluation loss as at 31 July 2021	

If it is assumed that on 31 July 2022, the asset increases in value to £50,000, the revaluation gain is recorded as follows:

	£
Dr PPE	20,000
Cr Profit and loss account	10,000
Cr Revaluation reserve	10,000
Being revaluation gain as at 31 July 2022	

In the 31 July 2022 financial statements, the previous revaluation loss of £10,000 has been reversed as the asset's value as increased. Hence, rather than take the whole revaluation increase of £20,000 to the revaluation reserve, £10,000 is recognised in profit and loss to reverse the previous revaluation loss as at 31 July 2021.

2.2.1 Revaluations and depreciation

FRS 102 is silent on how accumulated depreciation on an asset that has been revalued should be treated. This will require management to develop an accounting policy in line with FRS 102, paras 10.4 and 10.5.

While management need not refer to IFRS Standards when developing an accounting policy (as these are not in the list of mandatory sources in FRS 102, para 10.5 but are referred to as an optional resource in FRS 102, para 10.6), IFRS Standards may provide a useful starting point. IAS 16 *Property, Plant and Equipment* provides a choice of two methods:

Method 1: Adjust the gross carrying amount in a manner that is consistent with the revaluation of the carrying amount of the asset. The accumulated depreciation at the date of revaluation is adjusted so that it is equal to the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses.

Method 2: The accumulated depreciation is eliminated against the gross carrying amount of the asset.

Example: revaluation and depreciation

Revere Co owns a freehold building that has a carrying amount of £188,000 made up of cost of £200,000 and accumulated depreciation of £12,000. The property is revalued to fair value of £225,600.

	Method 1	Method 2
	£	£
Cost/valuation		
Prior to revaluation	200,000	200,000
Revaluation adjustment	40,000*	25,600
Post revaluation	240,000	225,600
Depreciation		
Prior to revaluation	12,000	12,000
Revaluation adjustment	2,400	(12,000)
Post revaluation	14,400	-
Revalued amount	225,600	225,600

Dr PPE
Cr Revaluation reserve

Dr Depreciation
Cr Revaluation reserve

***Property fair value increases by 20% (£225,600 - £188,000 / £188,000 x 100) hence an uplift of 20% on cost and 20% on depreciation.

2.2.2 Transfer between revaluation reserve and retained earnings

The Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) and The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409) state that an amount may be transferred from the revaluation reserve to retained earnings (profit and loss reserves) if that amount was previously charged to that account or represents realised profit.

There is no mandatory requirement to make this transfer but, if it is not done, the balance on retained earnings will understate the profits available for distribution. However, it is worth noting that even where this adjustment is made, there is no guarantee that the balance on retained earnings would be the same as distributable profit.

There are two types of transfer that can be undertaken:

(a) Each year, a transfer is made from the revaluation reserve to retained earnings equivalent to the excess depreciation that has been charged in respect of the revalued asset (ie the depreciation charged under the revaluation model less the depreciation that would have been charged under the cost model).

(b) When the entity disposes of the asset, the balance remaining on the revaluation reserve is transferred to retained earnings.

Example: reserves transfer

Tennyson Co has an item of PPE that is measured under the revaluation model. The annual depreciation charge under the revaluation model is £20,000, but under the cost model the depreciation charge would have been £15,000.

The difference of £5,000 may be transferred from the revaluation reserve to retained earnings so that the value of the revaluation reserve which becomes realised by the depreciation charge is correctly reflected in the equity section of Tennyson's balance sheet as only the depreciation charge calculated under the historical cost accounting rules should impact on the balance of retained earnings which are available for distribution.

2.3 Deferred tax

PPE measured under the revaluation model are non-monetary assets subject to revaluation and fall within the scope of deferred tax.

The rates used to calculate deferred tax are the tax rates and laws that have been enacted or substantively enacted by the reporting date and which will apply to the sale of the revalued asset.

As discussed in **1.5.2** above, for balance sheet dates ending on or after 24 May 2021, deferred tax in respect of timing differences that are expected to reverse on or after 1 April 2023 will need to be remeasured at 25% where taxable profits are expected to exceed £250,000, or at the marginal rate if taxable profits are expected to fall between £50,000 and £250,000.

Deferred tax in respect of PPE will follow its underlying transaction in the financial statements. Hence, for revaluation gains, a deferred tax liability (or movement therein) will be taken to the revaluation reserve. A reduction in a deferred tax liability for a revaluation loss will also be taken to the revaluation reserve. Where any element of gain or loss passes through profit or loss (due to part or all of the revaluation gain reversing a previous revaluation loss, or an excess loss being recorded in profit or loss), the associated deferred tax element will need to be split pro-rata between other comprehensive income and profit or loss.

August 2022