FRS 102 and Investment Properties

FRS 102 is mandatory for non-small companies with periods beginning on or after 1 January 2015 and comparatives (including the opening balance sheet) will need to be restated.

Section 16 of FRS 102 defines investment property as property (which can include land or only part of a building) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business.

There is also scope for an investment property to be held under an operating lease. This will arise if, and only if, the property would otherwise meet the definition of an investment property.

Is this definition different from SSAP 19? Yes, because SSAP 19.18 explicitly states that the following are not investment properties:

(a) A property which is owned and occupied by a company for its own purposes is not an investment property.

(b) A property let to and occupied by another group company is not an investment property for the purposes of its own accounts or the group accounts.

This second part (b) is important as properties which used to be let to a fellow group company will now potentially fall into the category of investment property under FRS 102.

What happens if part of the property is let but part of the property is used by the entity itself?

Under SSAP 19.18 that would have been accounted for as a tangible fixed asset as the entity occupied part of the property (irrespective of how much the entity used itself versus letting out). However under section 16 of FRS 102 you will now have a mixed use property and the fair value of the proportion of the area let should be quantified and accounted for as an investment property. Unless this component cannot be measured reliably (in the context of undue cost or effort) the whole property is accounted for as a tangible fixed asset. So we will now potentially see one property with an element of it being depreciated and held at cost (being property, plant and equipment) and another element being held at fair value and not depreciated (being investment property). The size of the investment property may be smaller than the size of the PPE element yet it may hold more value on its balance sheet. As an accountant this makes sense in light of what the property is being used for, but will this seem strange to a non-accountant?

How do we initially record an investment property under section 16 of FRS 102?

How much it cost to acquire (eg. purchase price, directly attributable expenditure such as legal fees, relevant stamp duty etc.) or if under a finance lease then the asset is recognised at the lower of the fair value of the property and the present value of the minimum lease payments. If the property has been constructed rather than purchased then SSAP 19.7 (a) only allowed the property to be classified as an investment property once construction work was completed whilst there is no such

prohibition under section 16 of FRS 102. As such the property could be included in investment property earlier under FRS 102 as long as it meets the definition above.

What about subsequent measurement?

SSAP 19 required investment properties to be carried at open market value with no depreciation whilst FRS 102 refers to fair value (with no depreciation); although this change in wording is not expected to lead to many differences at all in practice. For an unquoted asset the price of a recent transaction for an identical asset or a valuation technique provides evidence of fair value. Both open market value and fair value should be accounted for on an on-going basis (ie. at the end of each period). A key difference in FRS 102 is that a depreciated cost model can be used instead of the fair value approach. Let's analyse what the terms "depreciated cost model" and "fair value" mean:

Depreciated cost model

FRS 102 allows an entity to use a depreciated cost model when the fair value of the property cannot be measured without undue cost or effort (16.1). The FRC’s Staff Education Note 4 on investment properties notes that changes in fair value can normally be obtained so the use of undue cost or effort is unlikely.

The real question here is what exactly constitutes ‘undue cost or effort’. The ICAEW issued Technical Release 13/14 AAF (issues for auditors) at the back end of 2014 and in the case of an investment property it states the following should be considered:

- whether management has obtained a reliable fair value or equivalent previously and why management believe that this is no longer possible (ie. consider how they ensured compliance with SSAP 19 in previous years if it was an investment property);
- materiality of the investment property;
- context of the investment property in relation to the business / operation as a whole and any changes therein (ie. are they set up purely to invest in property or is it ancillary to their business?);
- users of the financial statements and extent of their interest in the fair value of the investment property and their understanding therein (eg. is there external finance supporting the business and is this property secured on that finance?);
- management’s rationale for concluding that cost or effort is undue; and
- alternatives available and permitted under the framework.

Although this has come from a Technical release for auditors it would appear to be a pretty good starting place for those who are involved in accounts compilation as well. This is going to need to be considered on an entity by entity basis and a blanket approach does not seem suitable.

If you are able to prove that fair valuing the asset would cause undue cost and effort then section 16 cannot be applied and the property is accounted for under section 17 instead, on tangible fixed assets (or PPE). As such these would be held at cost (less impairment) and depreciated over their useful economic life. This would not be deemed to be a change in accounting policy but is a change in circumstances. As such if it was previously included in investment property then the comparatives are not restated and the change in circumstance is dealt with by transferring the carrying amount of the investment property into tangible fixed assets at its ‘cost’.

Fair value

The definition of fair value is cross referenced to paragraph 11.27 in FRS 102 which lists out a hierarchy of calculating fair values:

1. Quoted price of identical asset – not relevant for investment properties;
2. Unquoted price of identical asset – if the same type of property has sold recently in the local market then the selling price of that property would be a viable fair value;
3. Valuation technique – if (b) did not give a good estimate of fair value then a valuation technique estimating the transaction price is an arm's length exchange would be used. For investment properties, this would usually lead to the consideration of rental yields to calculate a fair value.

The key point to note is that this is a hierarchy so checking the local property market should be considered prior to using rental yields as a valuation technique. Care will need to be taken here as many accountants and clients will prefer the rental yields valuation technique from a cost perspective. FRS 102 doesn't insist on the involvement of a professionally qualified valuer who has recent experience in the location and class of the property, but must disclose the extent to which such a valuation is used. If there has been no such valuation, then this fact should be disclosed together with the methods and significant assumptions applied in determining the valuation technique (eg. the director performed the valuation looking at the local property market over the last 12 months which has seen an X% increase in prices).

Transitional options

Section 35 of FRS 102 outlines certain transitional options available for first time adopters. In particular there are two areas which impact investment properties:

1. Using fair value at the date of transition as deemed cost; and
2. Using a previous GAAP revaluation at or before the date of transition as deemed cost.

These transitions options are only likely to be valid when the depreciated cost model is used so when we can use the depreciated cost model is the key question.

We now know when we can use the depreciated cost model for investment properties and the types of issues to watch out for. Just take care when using the 'undue cost of effort' clause to ensure it truly applies to that entity.

Investment property gains/losses – do they show a true and fair view?

If an investment property is held at fair value and accounted for under section 16 of FRS 102 then we need to consider what happens to any gains or losses that are made when fair valuing the asset at the end of the reporting period.

Under SSAP 19 these were accounted for as unrealised gains and losses and we took these to an investment revaluation reserve on an individual investment property basis. In particular para 13

required that these changes were not taken to profit and loss but shown through the statement of total recognised gains and losses (except when the changes were expected to be permanent in which case they were taken to profit and loss – such as an impairment). The big headline change to FRS 102 is that changes in fair value go through profit or loss and as such will show much greater volatility within the profit and loss account than previously seen.

What must remain clear however is that these revaluations are not realised gains or losses and must not be treated as such from a Company Law perspective. Entities must separate out distributable and non-distributable reserves in order to comply with the Companies Act 2006. ICAEW Technical Release 02/10 makes it abundantly clear that increases in fair value of investment property are not to be treated as a realised profit. So entities will need to keep a track of distributable reserves in order to prove whether they are making lawful dividends or not. From a practical point of view, firms may set up a separate TB code to identify all of the investment property gains and losses or they may choose to identify these through their statutory accounts. Para A4.28 of Appendix IV in FRS 102 states that presenting fair value movements that are not distributable profits in a separate reserve may assist with the identification of profits available for that purpose and to me, this seems like a sensible starting place. This should not be a revaluation reserve (as this is a specific reserve under Company Law) but either labelled as a separate reserve or a non-distributable profit reserve. The accounting policy should state what is recorded in such a reserve (eg. fair value changes in investment properties are recorded in the non-distributable profit reserve).

It is perhaps worth mentioning that gains and losses on investment properties shown through profit and loss would not be taxable for corporation tax.

These are the types of issues that clients will need to know about as they will impact previously reported profit or losses. Potentially covenants on external financing could also be affected. Upfront consideration of the impact on profits and thus any covenants must be performed prior to transition and any issues dealt with to those providing external finance.

True and fair override

Under SSAP 19, the use of measuring investment property at market value and not depreciating the asset was a departure from para 18 of Schedule 1 in SI 2008/410 which requires the depreciation of fixed assets with limited useful economic lives. This departure from legislative requirements was deemed necessary to show a true and fair view and as such this was disclosed as such. However, the move to accounting for investment properties at fair value with changes through the profit and loss account means we are now applying the ‘fair value’ and not the ‘alternative’ rules. The movement in fair value is now reflected in the profit and loss account thus not requiring a depreciation charge. As such no ‘true and fair’ override disclosure is required because they are already showing a true and fair view!

Deferred taxation on investment properties

After considering how to account for valuation changes in investment properties, we now need to move on to one of the most controversial areas of investment properties: deferred taxation.

Another key difference between accounting for investment properties under FRS 102 and current UK GAAP is the recognition of deferred tax under FRS 102. FRS 19 prohibits the recognition of deferred tax on timing differences when fixed assets are revalued unless there is a commitment to sell that fixed asset. However FRS 102 requires a deferred tax provision to be recognised on investment property that is measured at fair value irrespective of whether the entity is likely to sell the asset and rollover any relief. Such deferred tax is measured using the tax rates and allowances that apply to the sale of the asset except where the asset has a limited useful life and all of the economic benefits are expected to be consumed.

The easiest way to understand deferred taxation is to have a look at some simple figures:

Client ABC Ltd with a year end of 31 December. They don't plan to early adopt so the first set of accounts under FRS 102 will be the year ended 2015. December 2014 comparatives will need to be restated and to do that we will need to know the opening position for that year (eg December 2013).

Market valuation
at end of 2015: £2.6 million
at end of 2014: £2.3 million
at end of 2013: £2.0 million

No difference noted between open market value and fair value.
Original cost of £1.0million thus at December 2013 there is £1.0m sitting in an investment revaluation reserve (and thus £1.3 million at 2014).

When calculating the deferred taxation for the investment property we use the tax rates and allowances applying to the sale of the asset and thus look at the difference between the fair value and its indexed cost. Indexed cost has been calculated at £1.3 million at end of 2013, at the end of 2014 assumed to be £1.326 million and at the end of 2015 assumed to be £1.5912 million.

	2013	2014	2015
Valuation in accounts	2,000,000	2,300,000	2,600,000
Indexed cost	1,300,000	1,326,000	1,591,200
	700,000	974,000	1,008,800
Tax rate	20%	20%	20%
Deferred tax	140,000	194,800	201,760

As an opening transition adjustment the £140,000 of deferred tax liability needs to be recognised with the corresponding entry to the non distributable reserve (alongside the movement of the investment revaluation reserve of £1.0 million to a non distributable reserve). The net effect to the non distributable reserve will therefore be £860,000.

To restate the comparative, an extra £54,800 of deferred tax needs to be recognised (debit to tax charge for the year and credit to deferred tax liability). The gain of £0.3 million also needs to be moved from the investment revaluation reserve to current year profit and loss.

In 2015, an extra £6,960 of deferred tax needs to be recognised and the revaluation gain of £0.3 million will need to be recognised in the profit and loss account.