

Classification Issue of Non-Current Assets

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Introduction

ABC Ltd is a company incorporated and domiciled in Sri Lanka. Company has a building which owns to them and it has two floors. They have marketing department, information technology department and Accounts department in the second floor. But the first floor is rented out to a foreign customer.

Discussion of the Issue

The building has been acquired by ABC Ltd in 2012 for Rs. 50mn. This Company uses this building for both renting purpose and administration purpose. It has been rented out in 2014. Above two floors can be sold separately and measured reliably. But company has classified the whole building as a Property, Plant and Equipment under LKAS 16 (Property Plant and Equipment) and cost model has been used to measure the Property Plant and Equipment after recognition. As company's policy, if this is an Investment Property Fair value method is used.

"According to LKAS 16(paragraph 6), Property, Plant and Equipment are tangible items that,

- (a) Are held for use in the production or supply of goods or services , for rental to others for administrative purposes; and
- (b) Are expected to be used during more than one period."

According to standards Cost model or re-evaluation model should be selected for measurement after recognition (paragraph 30, 31).

"According to the LKAS 16 (paragraph 36), if an item of PPE is revalued, the entire class of PPE to which that asset belongs shall be revalued."

"According to LKAS 8 (paragraph 5), Accounting policies are the specific principles, bases, conventions, rules, and practices applied by an entity in preparing and presenting financial statement."

"Accounting policy can be changed only if;

- (a) the change is require by the SLFRS or
- (b) result in the financial statement providing reliable and more relevant information(paragraph 14)"

Here adopting revaluation model from cost model is a change in accounting policy as it changes the measurement basis from historical cost to fair value.

"According to LKAS 40(paragraph 5), Investment Property is property (land or a building or a part of a building or both) held (by the owner or by 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 purpose or

(b) Sale in the ordinary course of business.”

Although recognition criteria of investment property as per “LKAS 40 – Investment Property” are fulfilled by that one change, those properties have been classified as property, plant and equipment at cost model.

Implication of the Issue

Company has classified the whole building as a Non-Current Asset in the Statement of Financial Position under Property Plant & Equipment. According to the company’s policy they apply cost model to entire class of Property Plant and Equipment. But company’s policy is applying Fair value method to Investment Property. Because of that there is a fair value impact to the Statement of Financial Position.

Company has depreciated the whole building including Investment Property. Because of that profit is understated due to the over depreciation charge. The company didn’t recognize the change in fair value of Investment Property to the books. Therefore it caused to a Fair value impact (Gain or Loss) to the Statement of Comprehensive Income.

Conclusion and Recommendation

According to the LKAS 16, they have to recognize half of the cost of building as PPE. On the other hand the first floor is used to earn rentals. Therefore that floor is not belonging to the PPE. So it must be classified under LAKS 40 as an Investment Property.

According to the company’s policy they apply cost model to entire class of Property Plant and Equipment. But company’s policy is applying Fair value method to Investment Property. If an item of PPE is revalued, the entire class of PPE to which that asset belongs should be revalued (LKAS 16-paragraph 36). Therefore company should select revaluation model to value the Building. Therefore that whole building should be revalued at the time of rented out.

Revaluation surplus should be recognized as follows,

Cost of the building	Rs. 50,000,000
Revalued amount	Rs. 60,000,000
Revaluation surplus	Rs. 10,000,000

PPE = 1/2 of the building \longrightarrow Revaluation reserve Rs. 5,000,000

IP=1/2 of the building \longrightarrow Fair value gain Rs. 5,000,000

On the other hand LAKS 40 prohibits calculation of depreciation for the first floor. Therefore over depreciation amount should be adjusted to the financial Statement.

Incorrect Calculation of Depreciation for PPE (for whole building)

Rs. 50,000,000/10 = 5,000,000
Depreciation charged for PPE = 2,500,000
Depreciation charged for IP = 2,500,000

Dep. Calculation should be as follows,

Rs: 60,000,000/2 = 30,000,000 (1/2 of building = PPE)
Rs: 30,000,000/8(remaining useful life time) = 3,750,000
Depreciation charged for PPE = 2,500,000
Under depreciation amount =1,250,000
Over deprivation charged for IP =2,500,000

It is recommended to pass the following journals entries in the company's financial statement as follows;

- (a) Recognition of Investment Property
- | | |
|-----|---------------|
| IP | Dr 30,000,000 |
| PPE | Cr 30,000,000 |
- (b) Recognition of Revaluation Surplus
- | | |
|---------------------|--------------|
| PPE | Dr 5,000,000 |
| IP | Dr 5,000,000 |
| Revaluation reserve | Cr 5,000,000 |
| Fair value gain | Cr 5,000,000 |
- (c) Adjustment of net impact on incorrect depreciation charged
- | | |
|------------------|--------------|
| Accumulated Dep. | Dr 1,250,000 |
| Depreciation | Cr 1,250,000 |