

Cases on Asset Valuation

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Objectives

- Application of appropriate Accounting standards and valuation models

Overview

- PPE with nil net value and still in use
- Valuation of Artwork
- Accounting for spare parts

Case 1

Our machines are fully depreciated, but we still use them! What shall we do?

The problem is that as these machines are used beyond their useful life, they are fully depreciated and their carrying amount is zero.

Depreciation = 0

≠ Matching Principle



What's wrong with that?

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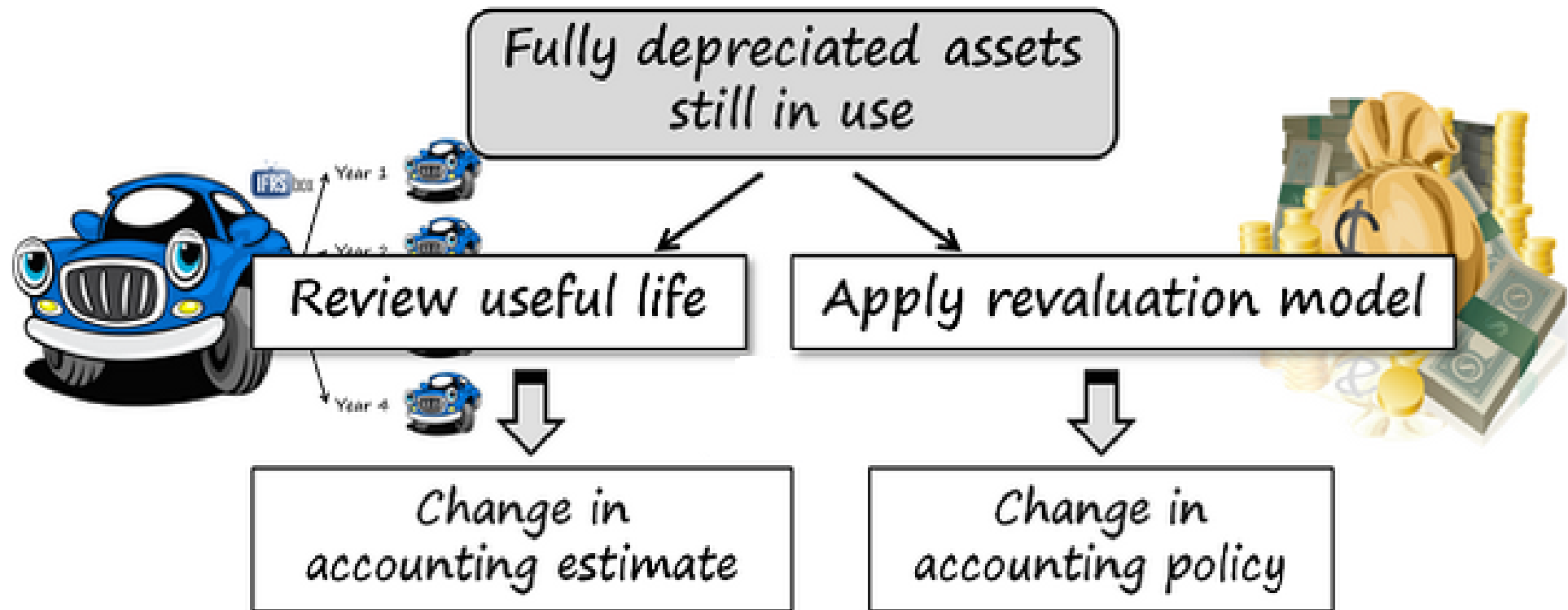


Identifying the problem

- The problem is in the machines' useful lives
- The standard IAS 16 Property, plant and equipment defines the useful life as either:
 - ❖ The period over which an asset is expected to be available for use by an entity, or
 - ❖ The number of production or similar units expected to be obtained from the asset by an entity.

How to fix the problem

- 2 possible corrective actions for this situation



Review useful life

Guiding standards

- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.
- No restatement of previous periods' financial statements is permitted. IAS 8 requires recognizing change in accounting estimates prospectively (now and in the future)
- What should I do when the carrying amount (net book value) of my assets is zero?
- Well, it depends.
- If you reviewed the useful lives in the past regularly and during the current reporting period you find out that you'd like to use the assets even longer, then there's not much to do. Just leave these assets as they are and make sure you avoid this situation in the future.
- However, if you really forgot to revise the useful lives in the previous reporting period, this failure to apply IAS 16 results in the accounting error.
- If this error is material, then you should correct it retrospectively in line with IAS 8. It means restating the previous periods using the revised estimated useful lives. Huge amount of work!

Revaluation Model

Guiding standards

- Standard IAS 16 permits 2 models for subsequent measurement of your property, plant and equipment: cost model and revaluation model.
- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Revaluing machines with nil book value would effectively mean that you are changing your accounting policy and here the standard IAS 8 gets the word again. In line with IAS 8, you shall change the accounting policy only if:
 - The change is required by an IFRS. This is definitely not the case.
 - The change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

Conclusion

- IAS 16 requires that the depreciable amount of an asset should be allocated over the asset's useful life (para 50).
- IAS 16 para 51 requires that the residual value and useful lives of PPE should be reviewed at least at each year end and, if expectations are different from previous estimates, the change should be accounted for as a change in estimate in accordance with IAS 8.
- Where an asset is held at nil net book value, this implies that the asset is still being used in the business but that it has been written off over a period shorter than its useful life, therefore contradicting the standard's requirements.
- IAS 8 requires that the effect of a change in estimated useful life should be accounted for by adjusting the depreciation charge for the current period insofar as the change affects the current period and by adjusting the charge for future periods to the extent that it affects the future periods.

IAS 16: PPE Bearer plants

Extended scope of IAS 16 PPE to include bearer plants and defines a bearer plant as

as a living plant that
a) Is used in the production process of agricultural produce

b) Is expected to bear produce for more than one period

c) Has a remote likelihood of being sold (except incidental scrap sales).

Measurement
-cost model
-revaluation model

Deemed cost exemption—use the fair value of the bearer plants

Transitional reliefs

Disclosures:
Quantitative on effect of adoption (IAS 8) will be required in future periods

Mandatory adoption for periods beginning on or after 1 January 2016

Case Two: Valuing Artwork

- How would you treat these paintings in your accounts under IFRS?
- IFRS do not contain any specific guidance applicable to “artwork” and therefore, we must stick with what’s in place.

Steps

- What kind of artwork do you have?
- Does your artwork have a determinable useful life?
- Is your artwork exposed to wear and tear?
- Does your artwork have some residual value? Can you sell it when you want to?
- Is your piece of art separable? Or is it attached to the other piece of property, for example – artistic painting on the wall?
- Does the value of your piece of art tend to increase with time rather than decrease? Does it have some historical or cultural value?
- Is the value of your artwork material for your financial statements?

Types of Artwork



Class 1: First Class Artwork

- Represents pieces that are held for capital appreciation purposes and decoration
- Primary goal for acquiring it is making an investment and as a store of value.
- IFRS do not contain any guidance in relation to this type artwork.
- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors will be applicable.
- It prescribes development of own accounting policy
- IAS 8 in paragraph 10 says that in the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is both relevant and reliable.

Class 1: First Class Artworkcontd

- How? Use “IAS 8 hierarchy”
- The requirements in IFRSs dealing with similar and related issues;
- The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework; and finally,
- The most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industries if they do not conflict with the sources in points 1 and 2

Class 1: First Class Artworkcontd

- Development of the policy: Refer to IAS 40 Investment property dealing with property acquired for capital appreciation or rental income, because the purpose of your first-class artwork is very similar.
- Fair value model appears to be the most appropriate for these assets, as they often have indefinite useful life, their fair value tends to increase over time (although not always) and they are held as a wealth store.
- Look to guidance in other accounting principles, for example, to UK GAAP and their FRS 30 Heritage Assets that deals with the similar items.

Class 1: First Class Artworkcontd

- Fair value model under IAS 40
- Under fair value model, the property is measured initially at cost including the transaction cost. Subsequently, the property is remeasured at fair value determined in accordance with the standard IFRS 13 Fair Value Measurement.
- Gains or losses arising from changes in the fair value of investment property must be included in net profit or loss for the period in which it arises.
- There's no depreciation.

Class 2: Office artwork

- Office artwork represents separate pieces, i.e. not attached to other items like walls that are held primarily for their use in business, while they might be resold from time-to-time.
- Includes all kinds of paintings, sculptures, replicas and other items held primarily for decorating your office or workplace in general.
- These items may have non-negligible acquisition cost, they might be produced specifically for you by the artist or purchased in galleries.
- They meet the PPE in line with IAS 16, as they are used either in a production of goods or services or for administrative purposes

Class 2: Office artwork....contd

- Accounting treatment for office artwork
- Use IAS 16 PPE
 - ❖ Cost model, under which you hold your assets at cost less depreciation less impairment loss; or
 - ❖ Revaluation model, under which you hold your assets at fair value at the date of revaluation less subsequent depreciation less subsequent impairment loss.

Guiding principle:

- If there's a market for these items and fair value can be obtained use revaluation model and revalue these items regularly. Otherwise use with cost model.
- Depreciation: If useful life can be determined depreciate if useful life is indefinite do not depreciate.

Class 3: Inseparable artwork

- Businesses hire artists to decorate their walls, for example, municipal swimming pool, sports stadium e.
- Treatment: treat the artwork as a subsequent expenditure related to an item of PPE in line with IAS 16. If the artwork brings some future economic benefits and its cost is reliably measurable, then you should capitalize it (not as a separate asset, but to the cost of the related PPE).
- For example, above mentioned municipal swimming pool argued that this crazy painting raised much more interest among people and the number of pool's visitors rapidly increased. As a result, pool's turnover increased, too.

Class 3: Inseparable artwork....contd

- Depreciate the artwork over its useful life.
- If you plan to remove or replace the artwork after few years, then depreciate it over these few years (artwork's useful life is not necessarily the same as the useful life of the related building).
- If you plan to leave it there until the building is destroyed or until the end of your lease, then depreciate it over the remaining useful life of the property.
- However, if the painting does not bring future economic benefit and is seen just as some servicing or maintenance, then you should expense it in profit or loss.

Common Artwork

- Represents all decoration pieces with relatively small acquisition cost, used solely for administrative purposes (not for capital appreciation), with no or very small residual value, often subject to wear and tear.
- Examples; posters, framed and unframed replicas, little statues, vases and other small things that can be acquired easily anywhere.
- Use IAS 16 exactly as the class 2. However, these items are rarely material and although they will be used mostly for more than 1 year and IAS 16 says nothing about the value threshold of PPE, it's OK to expense them right to profit or loss as some office supplies.
- Just be careful, because in some circumstances, these items can be material, if acquired in high amounts.

Common Artwork.....contd

- A local chain of real estate firm with over 500 apartments for rentals acquired about 500 pieces of framed posters from the Maasai Market for decoration of the apartments. One poster cost about 10,000 KES but total cost climbed to about 5,000,000 KES which was quite material for that particular company.

Accounting treatment

- IAS 16 does not describe the *unit of account*, or what constitutes an item of PPE.
- Apply judgment.
- Aggregate individually insignificant items and apply the criteria to the aggregate value

How to Account for Spare Parts under IFRS

- One of the biggest issues related to PPE is accounting for spare parts, servicing equipment, stand-by equipment and similar items.
- IFRS standards are pretty silent about this topic, the guidance is very limited and as a result, companies need to rely on careful assessment of the situation and their judgment.
- There are 2 main issues related to spare parts and similar items:

How to Account for Spare Parts under IFRS



Solutions

- You should be very careful in assessing whether you deal with IAS 2 or IAS 16, because the wrong selection can have serious implications on your financial statements, for example:
 - ❖ Incorrect measurement of your spare parts (depreciate or not?);
 - ❖ Incorrect presentation of your spare parts (non-current assets or current assets?)
- For all spare parts it's good to remember that in most cases, they are inventories.

Solutions...contd

- IAS 16, paragraph 8 specifically says that:
 - ❖ When major spare parts and stand-by equipment are expected to be used during more than 1 period, then they are accounted for as PPE
 - ❖ If spare parts and servicing equipment can be used only in connection with an item of PPE, then they are accounted for as PPE.

Solutions...contd

Consider the following criteria when assessing your spare parts:

a) Purpose of the spare parts

Are spare parts consumed in a production process (whether to produce goods or render services) or held as merchandise for resale?

- If yes, then it might indicate they are inventories.
- If not, then spare parts might be considered PPE.

b) Time aspect

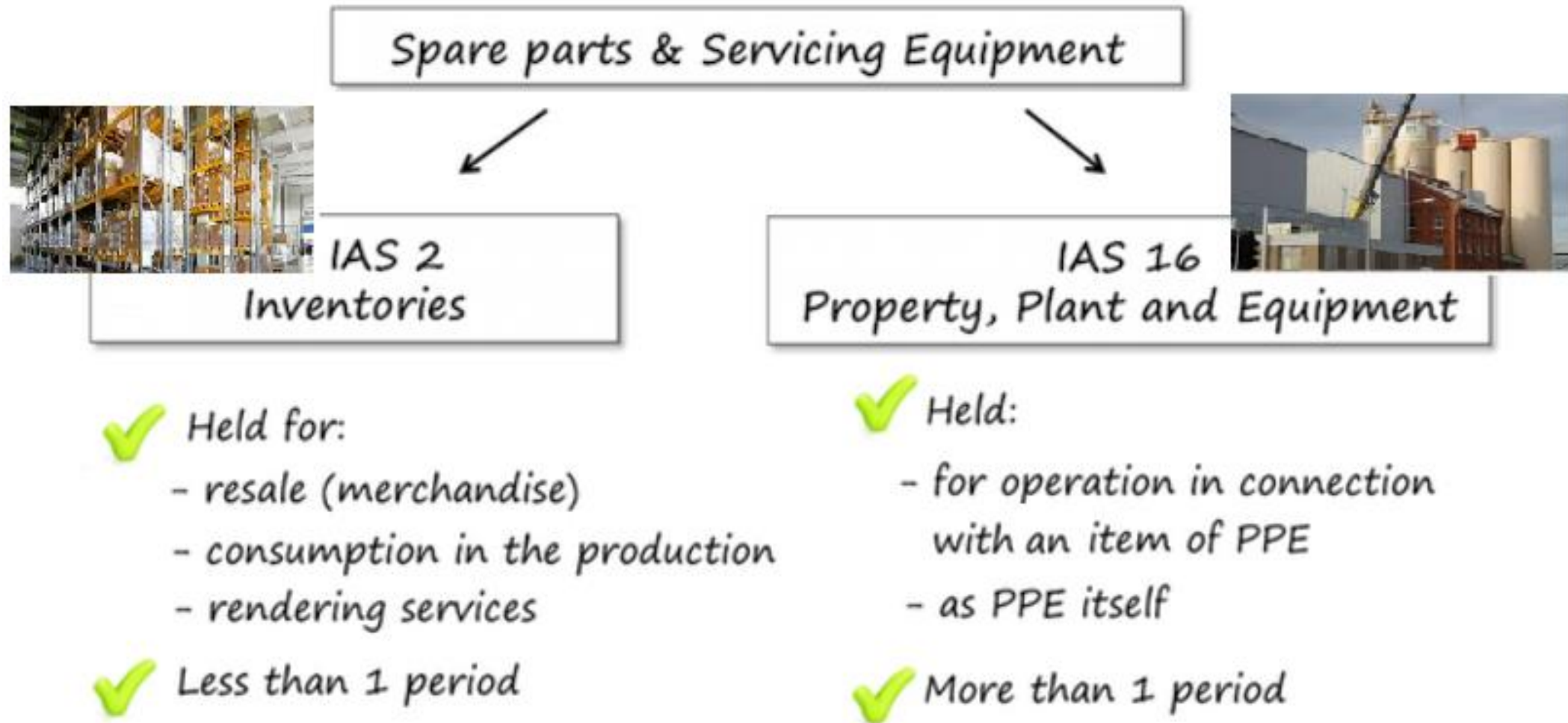
Do you need spare parts to operate some other asset during more than one period? Do you plan to use these items during more than 1 period?

- If yes, then they might be PPE.
- If not, then they are inventories.

Solutions...contd

- Materiality-is the value material. Should be guided by unit of account
- Unit of account
 - ❖ In such cases of small, numerous spare parts, it's practical and totally acceptable to apply paragraph 9 of IAS 16 and measure these small assets as 1 item of PPE – a set of assets.
- Minimum Levels:
 - ❖ Account for a minimum level of oil as for PPE, and for the remaining oil as for inventories.
 - ❖ “inventories” are not separable from an item of PPE and such “inventories” are in fact a PPE.

How to Account for Spare Parts under IFRS....contd



How to Account for Spare Parts under IFRS

- PPE may comprise parts with different useful lives.
- Depreciation is calculated based on each individual part's life.
- In case of replacement of one part, the new part is capitalised to the extent that it meets the recognition criteria of an asset, and the carrying amount of the parts replaced is derecognised.
- The cost of a major inspection or overhaul of an item occurring at regular intervals over the useful life of the item is capitalised to the extent that it meets the recognition criteria of an asset.
- The carrying amounts of the parts replaced are derecognised

Depreciation of Spare Parts in PPE

Depreciation should begin when an asset is available for use (IAS 13 para 55)

Depends on its nature, function and future use

Should you depreciate spare parts on replacement and when in operation or when in warehouse?

Depreciation of Major Spare parts

Critical spare parts

Capital spare parts

Start immediately

Start when installed

Not specified in the stds: use judgment



