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PROPERTY, PLANT AND EQUIPMENT, AND INVESTMENT PROPERTIES

Highlights of Technical Clinic

By
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Property, plant and equipment (PPE) is held for use in an entity's business activities. On the other hand, investment properties are held to earn rentals or for capital appreciation or both, rather than for use in an entity's business activities. As such, investment properties generate cash flows largely independently of the other assets, which are consistent with the intention of the management of the entity, in view of its investment potential. Lim Yeong Seng, Partner of Kong Lim & Partner LLP, facilitated the lively discussion among a group of practitioners. We bring you some of the highlights below.

Q1 IT IS A COMMON PRACTICE FOR AUDITORS TO ASSESS THE RISK OF MISSTATEMENTS FOR PPE AS BEING LOW. IS THIS APPROPRIATE?

It depends. If the PPE represents a significant portion of the entity's total assets, merely documenting the inherent risk of misstatement for PPE as low in the absence of risk assessment procedures is not adequate. The auditor should document the risk assessment procedures performed to provide a basis for the identification and assessment of the risk of material misstatements which include:

a) Inquiries of management during planning meeting or in the course of the audit fieldwork to identify the control procedures relating to PPE;

b) Analytical review procedures to identify any significant variances from the comparable information of prior periods, management's budgets and expectations formed at planning stage, and

c) Understanding the client and its environment through the observation and inspection of the entity's premises and plant facilities.

Q2 WHAT ARE THE INDICATORS OF A POTENTIALLY HIGHER RISK OF MISSTATEMENT IN THE AUDIT OF PPE?

The indicators that the auditor should consider are as follows (these are not exhaustive):

a) Weak internal control in the entity
No control over physical access of the entity's office premises may subject the entity to a higher risk of employee pilferage or assets being stolen.

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> **The fair value model requires an entity to perform valuation on its investment property on an annual basis. Any gain or loss arising from the changes in fair value will be recognised in the period it arises.**

b) Cumulative losses from an entity operating in a capital-intensive industry
A ship-owning entity that charters its vessels to third parties has been making continuous losses for the past few years, exposing the entity to a higher risk of the assets being impaired.

c) Inexperienced accounts staff employed by the entity
There is a higher risk of repair and maintenance expenses being capitalised as fixed assets cost.

d) Assets owned by an entity are mostly small and movable
Small and movable assets are susceptible to misappropriation by employees.

e) Complex accounting transactions
Assets that are subject to complex leasing and financing arrangements carry a higher risk of being inappropriately accounted for in the financial statements.

Q3 IS IT NECESSARY FOR THE AUDITOR TO PERFORM A PHYSICAL INSPECTION OF PPE EVERY YEAR?

It depends. Physically inspecting the PPE is a way of establishing its existence. The auditor can also inspect ownership documents such as original vehicle registration documents, title deed and finance lease agreement (accounted for by a lessee) to determine the existence of the assets owned by the entity. The extent of audit procedures to be performed depends on the auditor's assessment of the risk of material misstatement, which needs to be documented in the working paper.
The auditor should:

a) Consider the need to perform physical inspection of assets and the

frequency of such inspections, that is, whether it should be performed (i) annually; (ii) in alternate years, or (iii) every three years;

b) Where appropriate, use the sample selection planning template available in the *ICPAS Audit Manual for Small Companies* (or the firm's audit sampling methodology) to determine and justify the sample size, and

c) Document test of details including rationale for the audit approach, basis of sample size determination and selection, source of samples, audit procedures performed, findings, and results where the auditor concludes that it is not necessary to perform such audit procedures, such as where the PPE are not material to the entity, the rationale and conclusion should be documented.

Q4 IF THE MANAGEMENT REVISED THE USEFUL LIFE OF ITS PPE, IS THIS A CHANGE IN ACCOUNTING ESTIMATE OR A CHANGE IN ACCOUNTING POLICY? IS THE EFFECT OF SUCH CHANGE PROSPECTIVE OR RETROSPECTIVE?

Where the useful life of a PPE is revised as a result of a change in the expected pattern of consumption of the future economic benefits embodied in a depreciable asset, this is treated as a change in accounting estimates as stated in Financial Reporting Standards (FRS) 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Therefore, any change in accounting estimates should be effected prospectively by including it in (i) the profit or loss in the period of change, if it affects only that period, or (ii) the period of change and future period, if the change affects both.

We illustrate with an example of an entity that purchased an item of machinery at a cost of S$50,000 with an estimated useful life of 10 years. At the end of Year 3, the machinery has a carrying amount of S$35,000. Due to rapid technological changes

and operational requirement, the management decides to revise the useful life of its machinery to five years in Year 4. There is no impairment issue being determined for the machinery. Consequently, the carrying amount of that machinery is depreciated over the remaining useful life of five years at S$7,000 per annum. Depreciation charges for Years 1 to 8 will be as follows:

YEAR	DEPRECIATION CHARGE (S$)
1	5,000
2	5,000
3	5,000
4	7,000
5	7,000
6	7,000
7	7,000
8	7,000

Q5 IS IT NECESSARY TO PERFORM A VALUATION ON AN OWNER-OCCUPIED PROPERTY?

It depends. For owner-occupied property, under FRS 16 *PPE*, an entity can choose to measure that property using the cost model or the revaluation model. An entity that chooses to measure such property using the cost model is not required to perform a valuation unless there is indicator of impairment on that property. Some examples of indicators of impairment include adverse changes in the technological, market, economic or legal environment in which the entity operates, market capitalisation being lower than net assets and evidence of obsolescence or physical damage to the asset. Further guidance on indicators of impairment of assets is set out in FRS 36 *Impairment of Assets* para 111.

Conversely, if the entity measures that property using the revaluation model, the entity must be able to reliably measure the fair value of that property such that it can be carried at its revalued amount, being its fair value

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at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Any increase in the carrying amount of that property is recognised in other comprehensive income and accumulated in equity under revaluation surplus. An entity that chooses to measure such property using the revaluation model is only required to perform a valuation if there is an indication that the fair value of that property changes significantly. Otherwise, FRS 16 requires the entity to revalue that property only every three or five years.

Q6 CAN THE AUDITOR SIMPLY PLACE RELIANCE ON THE VALUATION REPORT PROVIDED BY THE PROPERTY VALUER WITHOUT FURTHER WORK DONE?

No. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's reliance on the work of an expert. The auditor should obtain sufficient appropriate audit evidence to conclude that the property valuer's valuation report is adequate for the purposes of the audit by performing the audit procedures as follows:

a) Evaluate the professional competence and objectivity of the expert:

- The auditor can discuss with management to understand the credentials of the expert engaged, and inquire whether there are other businesses or potential business dealings that the expert is engaged in which may affect his professional objectivity;
- The auditor can then corroborate with audit evidence through checks performed using search engines such as Google or Yahoo on whether the expert engaged is a member of a professional body or registered with a particular association or institute which requires him to comply with the relevant code of ethics and professional conduct;

b) Assess the adequacy of the scope of the expert's work and evaluate the appropriateness of the expert work as audit evidence for the purposes of the audit. The auditor should:

- Obtain an understanding of the basis of the valuation;
- Review or test the expert valuer's source data such as the use of discounted cash flows;
- Perform an independent assessment on the key assumptions and estimates used in the expert valuer's report, and
- Conclude whether the basis used by the expert is appropriate and reasonable, based on his knowledge of the business and results of other audit procedures.

The above audit procedures are a precondition to the auditor's use of the work of an expert as audit evidence. Purely relying on the valuation report without further audit procedures to check on its reliability and credibility is not acceptable. The requirements apply regardless of whether valuation reports provided by experts are desktop or formal valuations.

Q7 IS IT A MUST THAT AN ENTITY HAS TO MEASURE ITS INVESTMENT PROPERTY USING THE FAIR VALUE MODEL? WHAT IS THE MAIN DIFFERENCE BETWEEN THE COST MODEL VERSUS FAIR VALUE MODEL?

Generally, an entity can choose to measure its investment property using the fair value model or cost model. However, the choice between the fair value model and cost model is not available to a lessee accounting for a property interest held under an operating lease that meets the definition of an investment property and has been classified as such. In this scenario, FRS 40 *Investment Property* overrides FRS 17 *Leases*, and requires the lessee to account for the operating lease as if it is a finance lease. Also, FRS 40 requires such investment property to be measured using the fair value model.

We illustrate with an example of an entity that rents a building under an operating lease and subleases that building to others. The entity earns profits from its leasehold interest in that building by charging its tenants higher rental than the amount charged by its landlord. Hence, the entity has the option to account for that building in its book as an investment property as it fulfils the criteria in FRS 40. Where the entity chooses to do so, it will need to account for the operating lease of that building as if it is a finance lease and classify that building as an investment property. In such a scenario, that investment property can only be measured using the fair value model. Similarly, all other investment properties held by the entity are required to be measured using the fair value model.

The fair value model requires an entity to perform valuation on its investment property on an annual basis. Any gain or loss arising from the changes in fair value will be recognised in the period it arises. On the other hand, for an investment property measured using the cost model, the investment property is carried at cost less any accumulated depreciation and any accumulated impairment loss.

★ **Physically inspecting the PPE is a way of establishing its existence. The auditor can also inspect ownership documents such as original vehicle registration documents, title deed and finance lease agreement to determine the existence of the assets owned by the entity.**

Q8 IF AN ENTITY CHOOSES TO MEASURE ITS INVESTMENT PROPERTY USING THE FAIR VALUE MODEL, CAN THE ENTITY SWITCH BACK TO COST MODEL?

The answer is no. If an entity chooses to measure its investment property using the fair value model, it is not permitted to switch back to the cost model.

However, an entity that chooses to measure its investment property using the cost model can switch to using the fair value model at any point in time, when it is able to measure reliably the fair value of that investment property. However, once the entity switches to using the fair value model, it is not permitted to switch back to using the cost model to measure its investment property.

Q9 IF THE MANAGEMENT HAS A PROPERTY WITH A PORTION HELD TO EARN RENTAL AND ANOTHER PORTION USED AS AN OFFICE FOR ADMINISTRATIVE PURPOSE, CAN THE MANAGEMENT ACCOUNT FOR THE PORTIONS SEPARATELY?

FRS 40 states that if the management is able to sell or lease out (under a finance lease) the portions separately, the entity can account for the portions separately as Investment Property and PPE. For example, the management is able to split the property into separate portions through the strata title of the property owned. If the portions cannot be sold separately, the property should be accounted for as an investment property only if an insignificant portion is held for own use by the entity.

Q10 IF A PROPERTY IS CURRENTLY BEING TREATED AS AN INVESTMENT PROPERTY AND DISCLOSED ACCORDING TO FRS 40 USING THE COST MODEL, CAN THIS PROPERTY BE CLASSIFIED TOGETHER WITH FRS 16 *PPE* IN THE PRESENTATION OF THE FINANCIAL STATEMENTS?

The answer is no. The classification of whether the property owned by the entity is an investment property or PPE is determined by the use of that property by the entity. In most entities, investment property and PPE often represent the more significant asset categories.

Hence, to allow the user of financial statements to have a better understanding of the entity's financial position, the entity's PPE and investment property should be disclosed as separate line items. ISCA

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