Accounting for owner-occupied property: goldmine or landmine?

Adoption of AIFRS may have been expected to provide increased transparency in financial statements. However, the failure by corporates to adopt the flexibility and transparency offered by AIFRS for reporting owner-occupied property potentially creates landmines and goldmines, rendering financial statements less useful to recipients and raising risk management issues for shareholders, analysts and other interested parties.[1]

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SINCE THEIR INTRODUCTION for annual reporting periods beginning on or after 1 January 2005, Australian International Financial Reporting Standards (AIFRS) have attracted sustained criticism in the Australian financial press. Regular sources of complaint have included a lack of flexibility and a 'one-size-fits-all' approach, resulting in claims of reduced transparency in financial statements and diminished usefulness to recipients.

While the requirements of accounting for owner-occupied property under AIFRS may be considered extensive, arguably, they also offer flexibility to suit the varied uses of property by different corporates. Such flexibility may encourage increased transparency in financial statements, leading to potentially enhanced usefulness to recipients. However, it is unclear as to what extent corporates are availing themselves of the flexibility offered in accounting for owner-occupied property and whether there is any resulting increase in transparency rendering financial statements more useful to recipients.

Owner-occupied vs investment property

In examining the implications for AIFRS of owner-occupied property, it is relevant to focus on property which is owned by a corporate principally for occupation and use by that corporate. This may be distinguished from property which is owned principally for the purpose of investment, such as the property held by a real estate investment trust or listed property trust.

Under AIFRS, accounting for owner-occupied property is considered in AASB 116 (AASB, 2006) and investment property is considered in AASB 140 (AASB, 2006). Both AASB 116 and AASB 140 are based on the premise that the corporate is a going concern, requiring the entity to intend to retain the asset in continuous use (otherwise classifying such an asset as surplus) and also that the asset meets the test of adequate potential profitability in relation to the whole of the entity's assets.

Owner-occupied property is addressed in paragraph 6 of AASB 116, superseding the previous relevant Standard, AASB 1041 Revaluation of Non-Current Assets.

As will be considered further below, under AIFRS, corporates essentially have a choice between two alternative methods to account for owner-occupied property in financial statements – either the cost model or the value model.

Prior to the introduction of AIFRS, Leo et al. (2001) noted that, while the value model provides more relevant information than the cost model, it is also more expensive to adopt due to valuers' fees, management review time and record-keeping costs.

A survey of corporate Australia's adoption of AASB 1041 (Revaluation of Non-Current Assets, Ernst & Young 2002) provided some interesting insights into the attitude of corporates towards the cost model and the value model. The survey analysed the impact of the adoption of AASB 1041 by 129 corporates, finding that 30% of entities previously adopting the value model continued to do so following the introduction of the Standard.

Significantly, however, 40% of entities chose to change the basis of measurement from the value model to the cost model, with none choosing to adopt the value model instead of the cost model. Further, 60% of the changes to the basis of measurement were found to occur in the 'Land and Buildings' class.

The authors concluded that cost effectiveness and flexibility were two key factors affecting management's decision in choosing the measurement basis, citing references in the notes to financial statements that the costs of complying with the value model (being the potential requirement for regular independent valuations) exceeded the benefits (being improved relevance and reliability of financial information) that would be gained.

A clear undercurrent of comfort with the cost model is evident in some accounting texts, with references such as 'the valuation treadmill' (Deegan, 2004) indicative of a negative view of the value model.

Arguably the level of cost incurred in managing a valuation program for an owner-occupied property portfolio would not be significant relative to the total value of the portfolio. Similarly, with the increasing use of web-based reporting and decreasing use of printed financial statements, the costs incurred in reporting the greater level of data arising with the use of the value model would also appear to be insignificant.

The general lack of interest in and attention to the value model in financial statements is echoed in legal texts. Interestingly, Baxt (2005) notes case law concerning a failure by directors to value property purchased by the company, which was considered careless behaviour but was excused as the inadequate valuation of assets was not critical.

Accordingly, in the pre-AIFRS environment, a propensity to adopt the cost model to account for owner-occupied property in financial statements may have prevailed. To determine if this propensity continues in the post-AIFRS environment, a small cross-sectional study was undertaken, with the results being detailed below, following a brief consideration of the differences between the cost model and the value model under AIFRS.

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Cost model vs value model

Paragraph 15 of AASB 116 requires owner-occupied property, plant and equipment to be measured at cost on recognition. However, after recognition, an entity may choose to adopt either the cost model or the value model for application to an entire class of property, plant and equipment but, if the cost model is applied to land, this is not subject to depreciation.

The cost model requires determination of cost less accumulated depreciation and accumulated impairment losses, being the amount by which the carrying amount exceeds the recoverable amount. The recoverable amount is the higher of the fair value of an asset less the cost of sale or the value in use of an asset, which is an entity specific assessment. Accordingly, if the cost model is adopted, the recoverable amount for an asset should also be determined at balance date, requiring data from both the cost model and the value model for comparison.

For a large, complex, business specific property, such as a manufacturing plant, the cost model may be more appropriate. Such property may be designed and constructed to suit the specific requirements of the business and is assumed to have an ongoing use within a going concern. Accordingly, cost less depreciation is a logical method of determining fair value for the purposes of financial statements.

However, determination of the recoverable amount is potentially contentious. If the value model is adopted to determine fair value as the recoverable amount, a variety of challenges may arise. The alternative uses potentially permissible by a planning authority for the site may be unclear, the extent of costs associated with site remediation may be uncertain and so forth. Similarly, an entity specific assessment of value in use may be far from straightforward to determine.

Unless the determination of the recoverable amount is comprehensively undertaken, there is the potential for such aspects as site remediation to be understated and the value to be overstated, potentially creating a landmine in the financial statements.

Conversely, for smaller, less complex generic property such as warehouses or offices, contentious issues

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such as allowable uses under planning regulations and costs of remediation are potentially far less significant. However, escalating underlying land value or increases in market value levels for warehouse and office investments may produce a result using the value model that is far in excess of cost less depreciation. Where such a recoverable amount is higher, the corporate may elect not to realise this until disposal, potentially creating a goldmine in the financial statements.

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When using the cost model, AASB 116 notes that users of financial statements may find the gross carrying amount of any fully depreciated property, plant and equipment that is still in use to be 'relevant to their needs'. This prevents the building element of owner-occupied property from falling off the radar simply because it has been fully depreciated though it may still be of value and capable of sale or require expenditure for remediation. It does, however, question the validity of the cost model where the depreciation rate adopted would appear greater than the rate of depreciation occurring, effectively leading to mis-depreciation.

After recognition, a corporate may select the value model which requires fair value to be measured on a regular basis, to ensure that it does not differ materially from the carrying amount. The fair value of land and buildings is usually determined as their market value by appraisal from market-based evidence undertaken by a professionally qualified valuer (paragraph 32, AASB 116). While AASB 116 is not as detailed in its guidance on property valuation as its predecessor, AASB 1041, many of the relevant concepts for property valuers are addressed through the requirements of International Valuation Standards (IVSC, 2005).

A required frequency of valuation is not specified, but encouraged to be frequent for assets with 'volatile changes in fair value'. This is, however, qualified by a requirement that the entire class of property to which the asset belongs should then be revalued.

With over 100 commercial, retail and industrial property sub-markets in Australia, it is challenging for a corporate to monitor the relative volatility of each to determine the frequency of valuation. It may, therefore, be anticipated that corporates determine manageable classes of property and establish and maintain a rolling program of revaluations for the respective classes of property.

AASB 116 also requires the disclosure of whether an independent valuer was involved, the valuation method(s) adopted and, significantly, the carrying amount that would have been recognised had the assets been carried under the cost model for each class. For completeness, use of the cost model under AASB 116 also encourages disclosure of the amount that would result under the value model.

Adoption of a range of classes of owner-occupied property and provision of the above information for each, in accordance with AIFRS, may be expected to provide a high level of transparency in financial statements leading to potentially enhanced usefulness to recipients and a reduction in the likelihood of landmines or goldmines in such financial statements.

Approaches adopted by corporates: a case study

As noted above, previous research found that a propensity to adopt the cost model in financial statements prevailed in the pre-AIFRS environment. To determine if this propensity has continued into the post-AIFRS environment, a small cross-sectional case study was undertaken with the results detailed below.

The cross-sectional study comprised an analysis by web search of the most recent annual reports and financial statements for the 20 largest corporates by market capitalisation listed on the ASX at close of trading on 25 January 2008. While this approach to sampling captures Australia's largest corporates, it also provides a sample that is skewed towards the financial services and mining sectors.

The 20 largest corporates analysed had total balance sheet assets of $2,464,903 million of which property, plant and equipment comprised $125,161 million or 5.1% of total assets. Within property, plant and equipment, property represented only $16,025 million or 0.7% of total assets. Therefore, although the total property portfolio of Australia's 20 largest corporates is of substantial value, it only comprises less than 1% of total assets, which may influence the level of attention focused on its measurement by corporates.

Findings of case study

While AASB 116 favours the use of the value model, 80% of corporates by number have adopted a cost-based measure with only 20% by number adopting a value-based measure. For the five mining or energy companies, the use of the cost model may be justified by the absence of market-based evidence or the specialised nature of their assets, but there is no such justification for the balance of 11 companies.

Although a corporate could create a range of classes of property for transparent reporting using a sectoral (warehouse, office, residential, etc.), geographic (NSW, Queensland, Victoria, etc.) or operational (administration, manufacturing, storage, distribution, etc.) basis, 80% of corporates by number adopted three categories or less with land, buildings or leaseholds most common.

Within the 80% of corporates adopting the cost model, 50% explicitly addressed the issue of impairment losses thereby indicating that such corporates had actively considered the issue. Exactly how they had then addressed this in the preparation of financial statements was unclear, as was how the remainder had considered impairment losses. Only one corporate adopting the cost model disclosed an amount for fully depreciated property, plant and equipment on the balance sheet.

Within the 20% (four) of corporates adopting the value model:

- three explicitly addressed the frequency of revaluation;
- two explicitly addressed the date of valuation, with one specifying the day/month/year and the other specifying the year;
- only one explicitly nominated the independent valuation practice used, despite the additional confidence that the use of a specified valuer known for his/her expertise in a particular type of asset may provide to readers of financial statements; and
- three explicitly addressed the valuation method(s) adopted.

Although three corporates adopted an annual valuation frequency cycle, the approach of the minority was unclear.

Of the 20% (four) corporates adopting the value model, three stated the amount that would apply under the cost model, whereas, of the 80% or 16 corporates adopting the cost model, only two referred to the value model and none quantified the relevant amount under the value model. Effectively, 85% by number either were unaware or did not report the corresponding model.

Although AIFRS provides corporates with considerable scope to report a range of matters in financial statements that would assist with transparency, the overall reporting of such matters is surprisingly limited. It is particularly disappointing that the information which may be of most assistance to users of financial statements in determining the possible existence of landmines or goldmines, being the corresponding valuations under the cost model and the value model, was not reported by 85% by number of those corporates analysed, indicating a potential risk management problem.

In periods of high levels of stock market volatility, such as early 2008, it may be argued that information concerning the value of an owner-occupied property portfolio (even if only disclosed in the notes to financial statements) may be of considerably greater use to recipients than information concerning cost, which seriously questions the relevance of the cost model for financial statements.

Conclusion

It is ironic that AIFRS has been criticised for a lack of flexibility and a 'one-size-fits-all' approach, resulting in claims of reduced transparency in financial statements and diminished usefulness to recipients. In the context of reporting owner-occupied property in financial statements, the reverse would appear to be the case.

Through continued reliance on the use of the cost model, with limited supporting information, corporates are generally failing to avail themselves of the flexibility offered under AIFRS in accounting for owner-occupied property.

While adoption of the cost model is, in itself, less transparent than adoption of the value model, the unwillingness of corporates to then disclose all that AIFRS encourages to be disclosed under the cost model is particularly disappointing. The failure by corporates to adopt the flexibility and transparency offered by AIFRS for reporting owner-occupied property potentially renders the resulting financial statements less useful to recipients.

The reluctance by corporates to adopt the value model is perplexing. While corporates may claim that the value model is disproportionately expensive and time consuming, with owner-occupied property comprising less than 1% of total assets this would not appear likely to be a significant impost, particularly as owner-occupied property represents around $16,025 million of shareholder funds, which deserves a greater level of transparency.

Further, in periods of high levels of stock market volatility, such as early 2008, it may be argued that information concerning the value of an owner-occupied property portfolio (even if only disclosed in the notes to financial statements) may be of considerably greater use to recipients than information concerning cost, which seriously questions the relevance of the cost model for financial statements.

The provision of details of fair value under the value model, the valuer and the approach adopted to determine fair value, together with the amount that would have been recognised under the cost model, potentially provide a high level of transparency in financial statements.

Regular revaluations and their grounding in current open market transactions limit the potential for goldmines to become hidden in financial statements, thereby optimising shareholder value. Similarly, the investigation of alternative uses potentially permissible by a planning authority, and the potential costs of remediation etc. within the revaluation process, limit the potential for landmines to become hidden in financial statements, providing an effective additional source of risk management.

AIFRS provides a framework within which accounting for owner-occupied property in financial statements could be both very transparent and very useful to recipients. Regrettably, corporates currently choose not to fully avail themselves of the flexibility and transparency available under AIFRS, which limits the usefulness of such financial statements to recipients. This choice effectively renders it almost impossible for shareholders, analysts and other interested parties to ascertain whether a corporate's owner-occupied property portfolio includes any potential goldmines or landmines despite the consequent impact on shareholder value.

Notes

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