



ICPAS QUALITY ASSURANCE

Practical Guidance 2

DEPRECIATION OF FREEHOLD BUILDINGS



INTRODUCTION

1. The carrying amount of freehold buildings is usually a material balance on the balance sheet and significant to the financial statements. The common audit assertions related to freehold buildings are existence, rights & obligations and valuation.
2. Some common practical difficulties in determining the depreciation charge of freehold buildings include:
 - (a) Inability to determine the useful life of freehold buildings given the nature of the tenure; and
 - (b) Inability to determine the cost of freehold buildings in situations where land and buildings are acquired together and classified as a single class of property, plant and equipment.
6. Singapore Standard on Auditing (SSA) 540 "Audit of Accounting Estimates", paragraph 8 states that "The auditor should design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed".
7. The auditors can do so by critically assessing the factors that management has considered in determining the estimate which could include review of current market practice or making references to similar freehold properties in the same vicinity etc. As with all judgemental matters, auditors should assess the reasonableness of the useful life of freehold properties with an attitude of professional scepticism.

GUIDING PRINCIPLE

3. Financial Reporting Standard (FRS) 16 "Property, Plant and Equipment" states that "buildings have a limited useful life and therefore are depreciable assets". It also establishes that in situations where land and buildings are acquired together, they are to be accounted for separately (paragraph 58). Essentially, notwithstanding depreciation is not required for freehold land, freehold buildings will need to be depreciated. FRS 16 does not distinguish between freehold or leasehold buildings. All buildings will need to be depreciated regardless of tenure.
4. FRS 16, however, does not provide guidance in the determination of useful life of freehold buildings nor in the determination of cost of freehold buildings in situations where land and buildings are acquired together.

PRACTICAL APPLICATION

Determining the useful lives of freehold buildings

5. To apply a depreciation policy on freehold buildings, the fundamental measure that needs to be determined is the useful life of the buildings. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets (FRS 16, paragraph 57).

Determining the cost of freehold buildings

8. The other factor to consider is the depreciable amount of the freehold building which is usually determined after deducting its residual value. It is important to note that FRS 16, paragraph 54 states that "The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount".
9. In situations where land and buildings are acquired together, the cost of the freehold buildings will need to be segregated from the cost of the freehold land as mentioned in paragraph 3. This information could be obtainable from the sale and purchase agreement if the cost of land and building were separately determined at the time of purchase.
10. If no separate cost information is available, auditors will have to consider alternatives such as requesting management to engage an independent professional valuer to estimate the cost of the building, separate from the land cost at the point of purchase. When using the work of an expert like a professional valuer, the auditors would need to consider factors such as competence and objectivity of the expert, scope of the expert's work in evaluating the work of the expert, in accordance with SSA 620 "Using the Work of an Expert".

Quantifying the financial impact

11. The following example illustrates the accounting for the depreciation of freehold buildings in a scenario where the cost of freehold building and its useful life is determinable but no depreciation has been provided since the date of acquisition:

Example: Illustrating the quantification of impact retrospectively for depreciation of freehold buildings

FREEHOLD BUILDING ACQUIRED IN 1990 (NO DEPRECIATION HAS BEEN PROVIDED SINCE PURCHASE)		
Cost Of Freehold Building Determined (S\$)	1,000,000	[A]
Useful Life Determined (Years)	50	[B]
Annual Depreciation (S\$)	20,000	[C] = [A] / [B]
No Of Years From 1990 To 2007 (Years)	17	[D]
Depreciation From 1990 To 2007 (S\$)	340,000	[E] = [C] X [D]
Depreciation For 2008 (S\$)	20,000	
QUANTIFYING IMPACT OF PRIOR YEARS RETROSPECTIVELY		
	Dr/(Cr)	
	S\$	
Accumulated Depreciation	(340,000)	
Retained Earnings	340,000	
(to adjust retrospectively the depreciation from 1990 to 2007) (i.e. adjust against retained earnings in the statement of changes in equity as an error)		
QUANTIFYING CURRENT YEAR IMPACT		
Depreciation Expense	20,000	
Accumulated Depreciation	(20,000)	
(to adjust the depreciation for current year 2008)		

12. When the useful lives and costs of the freehold buildings could not be reasonably determined and no depreciation has been provided in the financial statements, this would not comply with FRS 16. Auditors will have to quantify, where practicable, the financial impact of the non-compliance on the financial statements and assess if there is any material misstatement. The auditors should also consider amongst others, the impact on the property, plant and equipment balance, net assets, total assets, validity of the going concern assumption, retained earnings and current year income statement.
13. Furthermore, arising from the above non-compliance, the auditor will have to consider if the audit opinion needs to be modified in accordance with SSA 701 "Modifications to the Independent Auditor's Report". An unqualified audit opinion may not be appropriate and the auditor has to consider if a qualified (except for) opinion on limitation of scope, a disclaimer of opinion or an adverse opinion is more appropriate in the context of the situation.

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PRACTICAL GUIDANCE

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