Q&A No. 2012-02

Cost of a new building constructed on the site of a previous building

Relevant PFRS

PAS 2, Inventories
PAS 16, Property, Plant and Equipment
PAS 40, Investment Property
PFRS 3, Business Combinations

Issue

When an entity which owns a property (consisting of land and an old building) constructs a new building on the site of the old building, how shall the entity account for the carrying value of the old building under the following scenarios?

Scenario 1: The entity acquired the property in the current reporting period, with the intention of demolishing the old building and replacing it with a new building. The entity will not use the old building prior to its demolition.

Scenario 2: The entity acquired the property in a prior reporting period and used it as owner-occupied property. In the current reporting period, the entity decides to demolish the old building and replace it with a new building.

Under each scenario, assume that the new building will be classified as:

(a) Owner-occupied property (or part of property, plant and equipment);

(b) Sold in the ordinary course of the entity’s business (or as part of inventories); or

(c) Held to earn rentals or for capital appreciation (or as part of investment property).

Background and Discussion

An entity may acquire a piece of land with one or more existing buildings, with the intention to either demolish the old building right away in order to construct a new building on its site as part of its planned redevelopment, or to initially use the old building as an owner-occupied property and then demolish it in a future period and replace it with a new building. The new building can either be:

(a) used as an owner-occupied property, which is within the scope of Philippine Accounting Standard (PAS) 16, Property, Plant and Equipment;

(b) sold in the ordinary course of the entity’s business, which is within the scope of PAS 2, Inventories; or

(c) held to earn rentals or for capital appreciation, which is within the scope of PAS 40, Investment Property.
When the old building is demolished to give way for the construction of the new building, there arises a question as to whether or not the cost allocated to the old building, or, in the case of a previously owner-occupied property, the carrying value of the old building as at the date the entity decides to demolish it, should form part of the cost of the new building. A related issue is how to account for the demolition costs incurred to physically tear down the old building.

**Allocation of cost of property to the land and building at date of acquisition**

Philippine Financial Reporting Standard (PFRS) 3.2(b) states that the acquisition cost of an asset or a group of assets that does not constitute a business “shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase.”

Applying this principle, the cost of the property acquired should be allocated to the land and the building at date of acquisition based on their relative fair values. The specific intention of the acquiring entity to demolish rather than use a building does not affect its fair value that will be used in the cost allocation. However, in circumstances where the existing building is unusable or is likely to be demolished right away by the entity acquiring it, the fair value of the existing building might be low and much less than the fair value of the land. This is because a rational buyer intending to demolish the existing building and construct a new building is unlikely to acquire a piece of land with a highly valuable building. In such cases, it may be appropriate to allocate the entire purchase price to the land. On the other hand, if the existing building is still usable and the acquiring entity intends to use it for a while before it is demolished in a future period, it will be inappropriate not to allocate any cost to the existing building. Hence, part of the purchase price shall be allocated as cost of the existing building which cost shall be depreciated over the building’s remaining estimated useful life.

**Classification of the property on initial recognition**

The classification of the property or the land and building will be as follows:

- **Scenario 1(a)** The land and building will be classified as two separate items under Plant, Property and Equipment measured at their allocated cost determined using the relative fair value method.

- **Scenario 1(b)** The land and building will be classified as one item under Inventories.

- **Scenario 1(c)** If the land and building will be subsequently measured using the fair value model, the land and building will be classified as one item under Investment Property.

  If the subsequent measurement of the property will be made using the cost model, the land and building will be classified as two separate items under Investment Property at their allocated cost determined using the relative fair value.

- **Scenario 2(a), 2(b) and 2(c)** As the entity, at date of acquisition, has decided to initially use the property as owner-occupied property, the land and building will be classified as two separate items under Plant, Property and Equipment measured at their allocated cost determined using the relative fair value method.
Elements of cost

The provisions in related PFRS that deal with the elements of costs are cited below:

For property, plant and equipment under PAS 16

“16 The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

“17 Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in PAS 19, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees.”

For inventories under PAS 2

“10 The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

“11 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the cost of purchase.

“12 The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a system allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. xxxxxxxx
“15 Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.”

For investment property under PAS 40

“20 An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.

“21 The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Directly attributable expenditure includes, for example, professional fees for legal services, property transfer taxes and other transaction costs.”

Consensus

Accounting for the Allocated Cost or Carrying Value of the Old Building

Applying the relevant PFRS provisions cited above, the allocated cost or carrying value of the old building shall be accounted for as presented below.

**Under Scenario 1**

Under Scenario 1, the entity intends to demolish the old building and will not use the old building prior to its demolition.

**Scenario 1(a): New building will be used as an owner-occupied property**

PAS 16 does not include any explicit guidance on whether the allocated cost or carrying value of an old building that will be demolished is part of the cost of the replacement building. Nevertheless, it is viewed that the allocated cost, if any, of the old building to be demolished is not a cost directly attributable to the new building as provided in PAS 16.16 (b) and PAS 16.17 cited earlier. Therefore, the allocated cost of the old building shall not form part of the cost of the new building. Also, since the old building will not be used, hence, no further economic benefits are expected from its use, the allocated cost of the old building should be de-recognized as required under PAS 16.67 and the loss arising from de-recognition is included in profit or loss as required under PAS 16.68.

**Scenario 1(b): New building will be sold as an inventory**

Development property (i.e., property intended for sale in the ordinary course of business, or in the process of construction or development for such sale) is within the scope of PAS 2 rather than PAS 16.

The cost of inventories under PAS 2.10 cited earlier is a somewhat lower threshold than the cost of an item of property, plant and equipment under PAS 16. For example, the cost of inventories under PAS 2.10 need not be directly attributable.

Accordingly, it is appropriate for the acquiring entity or property developer to include any cost allocated to the old building as part of the cost of the new building or development property that will be sold as an inventory.
**Scenario 1(c): New building will be held as an investment property**

Property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both is within the scope of PAS 40.

PAS 40.21 on what shall constitute the cost of investment property refers to “directly attributable expenditure” which is somewhat similar to the related provision under PAS 16. Accordingly, the consensus under Scenario 1(a) above can also be applied to Scenario 1(c), hence, the cost allocated, if any, to the old building shall not form part of the cost of the new building that will be held as an investment property. Also, since the old building will not be used, hence, no further economic benefits are expected from its use or disposal, any cost allocated to the old building should be de-recognized (eliminated from the statement of financial position) as required under PAS 40.66 and the loss arising from de-recognition is included in profit or loss as required under PAS 40.69.

**Under Scenario 2**

Under Scenario 2, the entity acquired the property in a prior reporting period and initially used the property as an owner-occupied property. In the current reporting period, it decided to demolish the old building and replace it with a new building.

As the building is a depreciable asset, the entity depreciates the cost allocated to the old building from the date of purchase on a systematic basis over the asset’s useful life, after considering any residual value. As required under PAS 16.51, the residual value and the useful life of the building shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change shall be accounted for as a change in an accounting estimate in accordance with PAS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

As provided under PAS 16.57, the useful life of an asset is defined in terms of the asset’s expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgment based on the experience of the entity with similar assets.

Applying the above principles, the entity, at the time it makes the decision to demolish the old building at a specific date in the future, has to re-compute the related depreciation charges on the building to depreciate the remaining carrying value of the building over the remainder of its life (or the remaining period before it is demolished). Hence, the old building will have a nil value at the date of the planned demolition.

If for some reason there is a remaining carrying value of the old building at the time of demolition, such amount shall not be capitalized as part of the cost of the new building; instead, such amount shall be charged to profit or loss. This is because:

(a) the carrying value of the old building represents the un-depreciated cost of the old building rather than a cost incurred in the construction of the new building; and

(b) the demolition of the old building is regarded as similar to a disposal for zero proceeds.
The above consensus applies to all situations under Scenario 2, i.e., Scenario 2(a) where the new building will be used an owner-occupied property, Scenario 2(b) where the new building will be sold as an inventory, and Scenario 2(c) where the new building will be held as an investment property.\(^1\)

**General Guidance on Accounting for Demolition Costs**

The demolition (or the physical tearing down) of the old building to give way for the construction of the replacement building will have related costs, referred to as demolition costs. There arises the issue on whether or not the demolition costs may be capitalized.

PAS 16.16(b) provides that any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management shall form part of the cost of the asset. The examples of directly attributable costs presented in PAS 16.17 cited earlier include ‘costs of site preparation.’

Demolition costs of the old building can be considered as part of costs of site preparation mentioned under PAS 16.17(b) and, therefore, may be capitalized. Although there is no clear guidance as to what account (i.e., land or new building) such demolition costs should be capitalized, it is preferable to capitalize the demolition costs as part of the cost of the new building since the demolition of the old building is a direct result of the decision to construct the new building.

**Effective Date**

The consensus in this Q&A is effective from the date of approval by the FRSC.

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\(^1\) This Q&A does not cover transfers to, or from, the investment property account; accounting for any such transfers shall be made in accordance with the relevant provisions of PAS 40.
Q&A approved by PIC: December 19, 2012 (Original signed)

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Q&A approved by FRSC: June 11, 2013