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MFRS Hot Topics

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

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Contents

Issue

If an entity constructs a new building on the site of a former building, is the carrying value of the old building part of the cost of the new building?

Relevant IFRSs
MFRS 102 Inventories
MFRS 106 Property, Plant and Equipment
MFRS 3 Business Combinations

Guidance

The carrying value of the old building is not part of the cost of the new building. Accordingly, the carrying value of the old building should be written off to the income statement when no further economic benefits are expected from its use (MFRS 106.67(b)). The costs of site clearance (including demolition) should however be included in the cost of the new building (MFRS 106.17(b)).

If an entity acquires land and buildings (outside of a business combination), the total acquisition cost should be allocated between the land and the buildings based on their relative fair values at the date of acquisition (MFRS 3.2(b)). If the building is demolished to make way for a replacement building, the cost allocated to the building is recorded as an expense.

However, if the land and the new building are inventory (i.e. development property rather than property, plant and equipment or investment property), we consider that it is permissible to include the cost of the old building in the cost of the inventory/ development property.

Discussion

Entities may own or acquire land with one or more existing buildings, with the intention of demolishing the old building in order to construct a new building on the site. This raises a question as to whether or not the carrying value of the old building is part of the cost of the new building.

MFRS 106.16 sets out that the cost of an item of property, plant and equipment comprises:

- its purchase price
- other costs directly attributable to bringing the item to the location and condition necessary for its intended use (directly attributable costs)
- if applicable, initial estimates of the cost of fulfilling obligations for site restoration and similar costs.

MFRS 106.17 goes on to identify examples of directly attributable costs. MFRS 106.19 identifies examples of costs that are not directly attributable. The standard does not however include any explicit guidance on whether the carrying value of a previous building (or other item of property, plant and equipment) is part of the cost of a replacement building. In our view, the previous carrying value is not a cost directly attributable to the new building. This is because:

- the carrying value of the old building represents un-depreciated costs of the old building rather than costs incurred in the construction of the new building
- we regard demolition as similar to a disposal for zero proceeds. MFRS 106.67 requires property, plant and equipment to be derecognised on disposal. MFRS 106.71 requires a gain or loss to be recognised on de-recognition equal to the difference between net disposal proceeds, if any, and the carrying value of the item.

This approach applies equally to an existing building and to a building acquired with the specific intention to demolish and replace. MFRS 3.2(b) explains that on acquisition of a group of assets that does not represent a business, the total cost is allocated between the assets and liabilities acquired. This principle applies to the purchase of land and buildings. MFRS 106.58 also states that land and buildings are separable assets and are accounted for separately.

The specific intention of the buyer to demolish rather than use a building does not affect its fair value (MFRS 3.BC262). However, in many circumstances the fair value of the existing building(s) might be much less than that of the land (although this should not be presumed). This is because a rational buyer intending to construct a new building is unlikely to acquire land with a highly valuable building. In some cases, the market for the old building might also be limited. For example, industrial buildings in an area in which industrial activity is in decline might have limited value. However, the land element might have substantial value for alternative use. These and other market-based factors will affect the relative fair values and therefore the cost allocation.

This discussion also applies if the new building is investment property (i.e. to be held primarily for capital appreciation and/or future rentals rather than for own use). This is because the cost model of MFRS 106 can also be used to determine the valuation of self-constructed investment property (MFRS 106.5).

Development property (i.e. property intended for sale in the ordinary course of business, or in the process of construction or development for sale) is within the scope of MFRS 102 rather than MFRS 106. MFRS 102 sets out a different recognition principle for the determination of cost. In terms of MFRS 102, the cost of inventories comprises 'all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition' (MFRS 102.10). This is a somewhat lower threshold than MFRS 106's. For example, costs for MFRS 102 purposes need not be directly attributable. Accordingly, we consider that the amount paid by a developer for a building to be demolished and replaced, or redeveloped can be treated as part of the cost of the new development property.

Examples

Entity A needs a site for a new warehouse and wishes to locate the warehouse close to its existing operations. The only available land in a suitable location has an existing factory. The entity agrees to acquire the land and factory for CU900,000. Entity A obtains an appraisal of the land and factory that indicates that:

- based on recent market transactions, the estimated fair value of the land is CU900,000. This reflects prices paid for land by a variety of purchasers including purchasers intending to use the land for a purpose other than its existing use
- the factory building has a fair value of CU100,000. This reflects the fact that there is a market for industrial buildings of this type and in this location, although potential purchasers are not generally prepared to pay as much for the land element as alternative use purchasers.

Entity A demolishes the factory building and realises CU40,000 in proceeds for certain scrap materials. It also incurs demolition and site clearance costs of CU50,000. It constructs a new warehouse on the site for further costs of CU500,000.

Analysis

In this example, the land has a fair value of CU900,000 and the building CU100,000. On a relative fair value basis, 90% of the acquisition cost of CU900,000 is therefore allocated to the land (CU810,000) and 10% to the building (CU90,000). (Note - it is not unrealistic that the fair value of the land and the building, when considered separately, add up to more than the combined fair value and the total amount paid. This is because the fair value of each element will reflect the highest price that could be obtained in the market for that element if sold separately. Thus, the reference market for the two elements might be different. In this example, the fair value of the land reflects the price that a non-industrial purchaser is willing to pay and the fair value of the building reflects the price that an industrial purchaser would pay.)

On demolition of the building, the carrying value (CU90,000) less scrap proceeds (CU40,000) is recorded as a loss on disposal.

The cost of the new warehouse is CU550,000, comprising demolition and site clearance costs of CU50,000 and other directly attributable costs of CU500,000.

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