

# Technical Accounting Alert

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

### Introduction

The purpose of this alert is to provide guidance about whether the carrying value of an old building can form part of the cost of the new building constructed on the site of the old building?

### Relevant Australian Standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

<b>International Standard reference</b>	<b>Australian equivalent standard</b>
IAS 16 Property, Plant and Equipment	AASB 116 Property, Plant and Equipment
IFRS 3 Business Combinations	AASB 3 Business Combinations

### Overview

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.

IAS 16.16 sets out that the cost of an item of property, plant and equipment comprises:

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

IAS 16.17 goes on to identify examples of directly attributable costs. IAS 16.19 identifies examples of costs that are not directly attributable.

### **Detailed guidance**

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.

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; and
- we regard demolition as similar to a disposal for zero proceeds. IAS 16.67 requires property, plant and equipment to be derecognised on disposal. IAS 16.71 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.

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 (IAS 16.67(b)). The costs of site clearance (including demolition) should however be included in the cost of the new building (IAS 16.17(b))

This approach applies equally to an existing building and to a building acquired with the specific intention to demolish and replace. IFRS 3.4 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. IAS 16.58 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. 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 (ie to be held primarily for capital appreciation and/or future rentals rather than for own use). This is because IAS 16 is also applied to determine the cost of self-constructed investment property (IAS 16.5 and 40.22).

### **Example**

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 \$900,000. 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 \$900,000. 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 \$ 100,000. 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 realizes \$ 40,000 in proceeds for certain scrap materials. It also incurs demolition and site clearance costs of \$ 50,000. It constructs a new warehouse on the site for further costs of \$ 500,000.

#### **Analysis**

In this example, the land has a fair value of \$ 900,000 and the building \$ 100,000. On a relative fair value basis, 90% of the acquisition cost of \$ 900,000 are therefore allocated to the land (\$ 810,000) and 10% to the building (\$ 90,000). (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 (\$ 90,000) less scrap proceeds (\$ 40,000) is recorded as a loss on disposal.

The cost of the new warehouse is \$ 550,000 comprising demolition and site clearance costs of \$ 50,000 and other directly attributable costs of \$ 500,000.

#### **Further information**

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at [NAS@grantthornton.com.au](mailto:NAS@grantthornton.com.au)