A Buildings Constructed on a Leasehold Land-A Revaluation Issue

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Introduction

PQR Company was incorporated under the Companies Act No: 17 of 1982 and re-registered under Companies Act No: 07 of 2007 domiciled in Sri Lanka. The principal activities of the Company are manufacturing & exporting of readymade garments.

The auditor carried out an annual audit and assurance engagement in PQR Company for the year ended 31st March 2017 and the identified accounting issue relates to the factory building of the Company.

Discussion of the Issue

PQR Company rented out a land from the government under the ‘99 Tax concept’ in 1989. The Company has constructed a building on that land in 2010 and construction cost of the building has capitalized to the land and buildings category in the Statement of Financial Position. The PQR Company did not pay any rental on the leasehold land until the end of 31st March 2017. According to the Company policies, all the property, plant & equipment have been revalued during the current year except the building constructed on leasehold land.

Since the ownership of leasehold land does not possess with the company, the accountant believes that the building constructed on leasehold land cannot be revalued as did for other classes of assets. Further, according to the accountant’s explanation, at the end of the lease period, the building constructed on leasehold land should be demolished and the bear land should be returned to the government. Therefore, the issue arising on this scenario is whether such building can be re-valued or not with other classes of asset.

Implication

This issue has implications on the financial statements, as the company failed to present their financial statements demonstrating the true and fair view. As a result, stakeholders may misinterpret the financial performance of the company.
Overall, the impact on financial statements can be shown as follows;

**Statement of Comprehensive Income:** As the Company presented their building at cost, depreciation of the building is understated. Therefore, profit for the year is overstated. On the other hand, company did not identify any gain or loss on revaluation in their financial statements. There is a revaluation gain of Rs 1.2Mn. Therefore, the Statement of Other Comprehensive Income (OCI) is understated by Rs 1.2Mn.

**Statement of Financial Position:** As the Company reported this building at cost, the book value of the building is understated by Rs 1.2Mn.

**Statement of Changes in Equity:** As revaluation reserve on building has not been identified, the revaluation reserve is understated by Rs.1.2Mn.

**Conclusion & Recommendations**

According to the LKAS 16 - *Property, Plant and Equipment* paragraph 36 states that, revaluation of Property Plant and Equipment should be performed as follow;

“If an item of property plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued”

And also, class of asset is defined as follows;

“A class of property, plant and equipment is a grouping of asset of a similar nature and used in an entity’s operations”

In practically, land has indefinite useful life time compared to the building. Therefore, at the end of the leased period the building constructed will be fully depreciated.

Finally, the auditors recommended to revalue the building constructed on leasehold land with other classes of assets and to rectify the accounting treatments, by adjusting Journal entries as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>1.2Mn</td>
<td></td>
</tr>
<tr>
<td>Other Comprehensive Income</td>
<td></td>
<td>1.2Mn</td>
</tr>
</tbody>
</table>

(Being recorded revaluation gain on the building)

<table>
<thead>
<tr>
<th>Account</th>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation (Building) (8%)</td>
<td>0.096Mn</td>
<td></td>
</tr>
<tr>
<td>Accumulated Depreciation (Building)</td>
<td></td>
<td>0.096Mn</td>
</tr>
</tbody>
</table>

(Being recorded depreciation on revalued building)