

**Q&A
CNC
16/007**

QUESTIONS / ANSWERS:
**LAND AND BUILDINGS UNDER THE LUX GAAP REGIME:
APPLICATION OF THE COST MODEL**

Questions:

The LUX GAAP regime¹ provides in its Article 55 (1) b) LRCS that "*the purchase price or production cost of fixed assets with limited useful economic lives must be reduced by value adjustments calculated to write off the value of such assets systematically over their useful economic life*". Article 55 (1) (c) (bb) LRCS goes on to provide that "*whether their useful economic lives are limited or not, so that they are valued at the lower figure to be attributed to them at the balance sheet date if it is expected that the reduction in their value will be permanent [durable]*".

In practice, these provisions give rise to a number of interpretative issues, particularly with regard to the valuation / measurement under LUX GAAP of the asset caption "C.II.1. Land and buildings"². More specifically, as part of the preparation of the annual accounts, the following questions arise:

- the principle of separate valuation / measurement of land and buildings (see point 2);
- the systematic depreciation obligation (see point 3);
- consideration of a residual value (see point 4);
- the admissibility of a component-based approach (see point 5);
- the impossibility of substituting the obligation to make systematic depreciation (art. 55 (1) b) LRCS with the obligation to make additional value adjustments in the event of a durable impairment (art. 55 (1) c) bb) LRCS) (see point 6.).

Keywords: art. 55 (1) b) LRCS, art. 55 (1) c) bb) LRCS, accounting directive 2013/34/EU, art. 52 LRCS, art. 64*sexies* LRCS, art. 54 LRCS, art. 55 (1) a) LRCS, art. 55 (1) e) LRCS, IAS 16, Property, plant and equipment, land, building, construction, depreciable base, systematic depreciation, permanent [durable] impairment, residual value, component approach

Answers:

1. Reminder of property valuation / measurement models

The Accounting Directive 2013/34/EU provides for the use of three accounting valuation / measurement models, namely the "cost" model in Article 6 para 1 point i), the "revaluation" model in Article 7 and the "fair value" model in Article 8 para 1 point b).

In Luxembourg, two models are currently authorised under the LUX GAAP and LUX GAAP – FV:

- the historical cost model referred to in Article 52 LRCS (LUX GAAP)
- the fair value model referred to in article 64*sexies* LRCS (LUX GAAP – FV)

¹ See: Q&A CNC 14/001 "*Luxembourg accounting law applicable to undertakings: three distinct regimes*" (formerly Q&A 01/2014)

² Cf: Layout of balance sheet 2016 in accordance with the Grand-Ducal regulation of 18 December 2015 determining the form and content of the layouts presenting the balance sheet and the profit and loss account, Annex I, *Mém. A - N°258* of 28 December 2015.

**Q&A
 CNC
 16/007**

QUESTIONS / ANSWERS:

**LAND AND BUILDINGS UNDER THE LUX GAAP REGIME:
 APPLICATION OF THE COST MODEL**

On the other hand, the revaluation model is not available under either LUX GAAP or LUX GAAP – FV in the absence of the adoption of a Grand Ducal regulation implementing Article 54 LRCS³.

The purpose of the following section is to explain certain procedures / practicalities for applying the historical cost model under LUX GAAP to the asset item "C.II.1. Land and buildings".

2. The principle of separate valuation / measurement of land and buildings

Land and buildings are sometimes acquired together by the undertaking and/or managed by the undertaking as if they were a single asset. In this context, the question arises of the accounting nature of the asset item "C.II.1. Land and buildings": single asset or separate assets?

IAS 16⁴ as adopted by the European Union (IFRS regime – EU⁵) settles this issue by stating that "*land and buildings are separate assets, treated separately in the accounts even when acquired together*". Such an analysis would also seem to be required under the provisions of the Accounting Directive 2013/34/EU, from which the LUX GAAP regime derives. The effect of this accounting classification as separate assets is, in particular, that:

- **at the time of purchase of the property**, and in particular when the land and building are purchased together, the total purchase price must be allocated – at a minimum – between the purchase price of the land and the purchase price of the building. Where the deed of purchase does not provide for such an allocation of the purchase price, it must be carried out by the undertaking's administrative or management body, which may – but is not obliged to – be assisted in this task by an independent appraiser;
- **when drawing up the annual accounts** and in application of the principle of separate valuation / measurement of assets referred to in Article 51 paragraph (1) point e) LRCS, no compensation / offset can be made between land and buildings. As a result, "*An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building*" (IAS 16 para. 58).

Under LUX GAAP (cost model), land and buildings are always separate assets that must be valued / measured separately at the time of acquisition (allocation of the purchase price) and subsequently when the annual accounts are drawn up. In application of the principle of separate valuation / measurement of assets, no offsetting can be made – for example – between unrealised capital gains on land and unrealised depreciation on buildings.

³ See: Q&A CNC 14/002 "Revaluation of fixed tangible assets" (formerly Q&A 02/2014)

⁴ International Accounting Standard 16 (IAS 16) *Property, plant and equipment*

⁵ Cf. supra note 1.

**Q&A
CNC
16/007**

QUESTIONS / ANSWERS:
**LAND AND BUILDINGS UNDER THE LUX GAAP REGIME:
APPLICATION OF THE COST MODEL**

3. The systematic depreciation obligation: compensation for the limited useful life

It is generally accepted under LUX GAAP that tangible assets have – by their very nature – a limited useful life, with the exception of land⁶. In the case of buildings, it should be noted that their useful life is not based solely on physical considerations but also depends on factors such as commercial, technical and regulatory obsolescence. As a result, although maintenance and improvement work extend the useful life of a building, this does not make it a fixed asset with an indefinite life.

LUX GAAP provides in its Article 55 (1) b) LRCS that the cost of *"fixed assets with limited useful economic lives must be reduced by value adjustments calculated to write off the value of such assets systematically over their useful economic life"*.

It follows from the above that, unlike land, buildings, which are assets with a definite useful economic life, must be systematically depreciated. The mandatory nature of systematic depreciation under the "cost" model was expressly confirmed in an interpretative communication from the European Commission⁷ concerning certain articles of the Fourth Council Directive and the Seventh Council Directive on accounting (98/C16/04). Point 30 of this interpretative communication states that: *"the depreciation obligation also applies to buildings whose fair value is equal to or higher than the book value or whose estimated residual life is unlimited or, in any event, so long that the annual amount of depreciation would be negligible. The directive stipulates that fixed assets, such as buildings, with a limited useful life should be depreciated over the same period. The objective of depreciation is to spread the acquisition price systematically over the useful life of the building in question"*⁸.

Under LUX GAAP (cost model), buildings included in fixed tangible assets are subject to systematic depreciation, as a direct consequence of the limited useful economic life of this asset category. Conversely, with certain exceptions (e.g. quarries), land is not systematically depreciated under LUX GAAP (cost model).

⁶ With a few exceptions, such as quarries and landfill sites, land has an unlimited / indefinite useful economic life and is therefore not depreciated (IAS 16 para. 58).

⁷ Interpretative communication of the European Commission concerning certain articles of the Fourth and Seventh Council Directives on accounting (98/C16/04) - OJ C 16, 20.1.1998, pp. 5-12

⁸ In point 31 of its interpretative communication, the European Commission goes on to state that *"the application of a valuation method not based on the acquisition price is another matter"*.

**Q&A
CNC
16/007**

QUESTIONS / ANSWERS:
**LAND AND BUILDINGS UNDER THE LUX GAAP REGIME:
APPLICATION OF THE COST MODEL**

4. Taking residual value into account

Like the Accounting Directive 2013/34/EU, the LUX GAAP regime is silent on the determination of the depreciable amount of fixed assets with a limited useful economic life, such as buildings and constructions, and in particular on the possibility of taking into account a residual value. In this respect, the above-mentioned Interpretative Communication provides a useful clarification by specifying in point 34 that *"the depreciation base, or depreciable amount, is constituted by 'the acquisition price or the cost'. In accounting practice, however, the depreciable value of an asset is sometimes determined after deducting its residual value. Although the Directive does not expressly mention residual value, its use in calculating the depreciable value of an asset is not contrary to the Directive.*

As a result, under LUX GAAP, the depreciable amount of an item of property, plant and equipment with a finite useful economic life may also be calculated as the difference between its historical acquisition cost and its residual value. However, the methods for determining the residual value need to be specified.

As the Accounting Directive and the LUX GAAP regime are silent on the concept of residual value, and as the European Commission's Interpretative Communication confined itself to specifying that the concept of residual value is compatible with the Directive without defining it, it seems appropriate to refer to the definition proposed by the IFRS accounting standards as adopted by the European Union (IFRS – EU regime). In this respect, paragraph 6 of IAS 16 as adopted by the European Union defines the residual value of an asset as *"the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life"*. It can be inferred from this that the aim is not to estimate the value of the asset at the end of its useful life, but rather to assess it at the acquisition date for a similar asset that would have been used over the same period. This estimate of residual value will have to be revised *"if expectations differ from previous estimates"* (IAS 16 para. 51). Changes in the measurement of residual value are treated as changes in accounting estimates, the effect of which is recognised in the profit and loss account for the current period.

Under LUX GAAP (cost model), the depreciable amount of an asset with a finite useful economic life may include – in its determination – a residual value for the asset, the initial estimate of which, and its periodic review, are the responsibility of the administrative or management body.

**Q&A
 CNC
 16/007**

QUESTIONS / ANSWERS:

**LAND AND BUILDINGS UNDER THE LUX GAAP REGIME:
 APPLICATION OF THE COST MODEL**

5. The admissibility of a component-based approach

As Directive 2013/34/EU and the LUX GAAP regime are also silent on the question of how depreciation is calculated and – in this case – on the admissibility of a component-based approach, it again seems appropriate to refer to the definition proposed by IFRS accounting standards as adopted by the European Union (IFRS – EU regime). Under IAS 16 as adopted by the EU, "*Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately*" (IAS 16 para. 43). Each significant component has a distinct useful economic life and residual value. In the case of a building, the structure tends to have a longer useful life than the electrical, plumbing or heating installations or the fixtures and fittings (doors and windows, partitions, etc.). According to this approach, "*An entity assigns the amount initially recognised in respect of an item of property, plant and equipment to its significant parts*" (IAS 16 para. 44).

Although the components approach is not a requirement under LUX GAAP, it is possible to apply it as it complies with the general principles and contributes to the objective of a true and fair view.

Under LUX GAAP (cost model), undertakings have the option – but are not obliged – to adopt a component-based approach in assessing the systematic depreciation of the various elements of the construction. Under this approach, each significant component is assigned a useful economic life and – where appropriate – a separate residual value. Alternatively, undertakings may systematically depreciate the building as a whole using a composite depreciation rate that faithfully reflects the average life of the building based on the relative value of its various components.

6. The impossibility of substituting the obligation to make systematic depreciation (art. 55 (1) b) LRCS) with the obligation to make additional value adjustments in the event of permanent [durable] impairment (art. 55 (1) c) bb) LRCS).

Among the interpretative issues raised by articles 55 (1) b) LRCS and 55 (1) c) bb) LRCS is the question of the need to apply the systematic depreciation provided for in Article 55 (1) b) LRCS to the "buildings" asset when the fair value of the "land and buildings" is higher than the net book value of these items. In other words, the question has arisen – in this specific situation – as to whether undertakings may substitute the obligation to make systematic depreciation (art. 55 (1) b) LRCS) with the obligation to make value adjustments in the event of a permanent / durable impairment (art. 55 (1) c) bb) LRCS).

The above developments lead to the conclusion that it is impossible – in the cost model under LUX GAAP – to substitute the systematic depreciation of the "building" with the value adjustment in the event of permanent / durable impairment (art. 55 (1) c) bb) LRCS) on the combined "land and building".

**Q&A
CNC
16/007**

QUESTIONS / ANSWERS:
**LAND AND BUILDINGS UNDER THE LUX GAAP REGIME:
APPLICATION OF THE COST MODEL**

The above analysis shows that:

- Land and buildings are separate assets subject to the principle of separate valuation / measurement, with no possibility of offsetting unrealised capital gains on one asset (land with an indefinite useful economic life) against unrealised depreciation on the other (buildings with a finite useful economic life);
- The systematic depreciation of property, plant and equipment with a finite useful economic life is an obligation confirmed by the European Commission.

As a result, the obligation to make value adjustments in the event of permanent / durable impairment applies to fixed tangible assets with a limited / definite useful economic life (e.g. buildings) only in addition to the systematic depreciation obligation, which cannot be waived. On the other hand, this obligation to make value adjustments in the event of durable impairment applies primarily to fixed tangible assets with an indefinite useful economic life (e.g. land, with certain exceptions) in the absence of a systematic depreciation obligation.

Under LUX GAAP (cost model), there can be no derogation from the obligation to systematically depreciate fixed tangible assets with a definite useful economic life. The replacement of systematic depreciation by a value adjustment in the event of permanent / durable impairment is not valid, as the latter is designed as a supplement to – and not as an alternative to – the former.

7. Conclusions on the application of the cost model to land and buildings under LUX GAAP

On the basis of the above considerations, it can be concluded that under the LUX GAAP cost model:

- land and buildings are two distinct assets that must be valued measured separately;
- there can be no compensation / setoff between unrealised capital gains on the land and unrealised depreciation on the building;
- construction must always be systematically depreciated;
- a residual value can be taken into account;
- a component-based approach can be adopted;
- the obligation to systematically depreciate fixed assets with a finite useful economic life (art. 55 (1) b) LRCS) cannot be replaced by the obligation to make value adjustments in the event of permanent / durable impairment (art. 55 (1) c) bb) LRCS), as the latter is complementary to the former;
- the undertaking must apply its accounting policies consistently to all assets in the same category.

Q&A CNC 16/007	<u>QUESTIONS / ANSWERS:</u> LAND AND BUILDINGS UNDER THE LUX GAAP REGIME: APPLICATION OF THE COST MODEL
-----------------------------------	--

Disclaimer

This document – provided as a courtesy – is an unofficial translation of the French original document entitled “Terrains et constructions en régime LUX GAAP : modalités d’application du modèle du coût”. In case of discrepancy in interpretation, the French version shall prevail.

The “questions and answers” published by the “Commission des normes comptables (CNC)” (Accounting Standards Board):

- are of a general nature and do not refer to the specific situation of any natural or legal person;
- are intended to contribute to the development of accounting doctrine in accordance with Article 73(b) of the amended Law of 19 December 2002 on the trade and companies register, as well as on the bookkeeping and annual accounts of undertakings;
- only represent the opinion of the GIE CNC on a number of doctrinal and interpretative issues.

The administrative or management bodies of undertakings remain responsible in accordance with general law for any decisions taken based on this document.