

**IAS 16 and the Revaluation Approach:
Reporting Property, Plant and Equipment at Fair Value**

Sarah E. Monday

Senior Honors Thesis

8 December 2008

Introduction

The term property, plant and equipment is used to describe tangible assets that are long-term in nature and are acquired for use in operations. These assets generally include such items as buildings, machinery, furniture, land and vehicles. Other terms for this category of assets include plant assets and fixed assets. Items of property, plant and equipment are generally distinguished from current assets because fixed assets are not easily converted into cash. Property, plant and equipment is presented in the financial statements on the balance sheet as a noncurrent asset. Additionally, amounts spent to acquire fixed assets and amounts received from the disposition of fixed assets are included on the income statement as gains or losses and on the statement of cash flows as investing inflows or outflows.

Many issues and questions arise during the process of accounting for items of property, plant and equipment, including determining an asset's useful life, which depreciation method to employ and how to account for impairment of long-term assets. Among the most important of these issues is deciding at which amount to value such items - at their historical cost, which is the price originally paid, or at fair value, which could be one of several metrics that reflect the current value of the asset. The question about the "cost" of items of property, plant and equipment continues to be debated among accounting practitioners and standard setters. Given the expected convergence of the world's major accounting standard setters, understanding the revaluation approach is increasingly important, as more companies are likely to implement this method as it becomes universally accepted. This paper purports to help readers gain insight into

the complexities of the revaluation approach, both at a conceptual level and in the technical application of the method.

Standards and Standard Setters

The accounting profession has faced an identity crisis lately. Currently, the profession is living a double life: some of its practitioners worldwide follow the rules-based, U.S. Generally Accepted Accounting Principles (GAAP) while others adhere to International Financial Reporting Standards (IFRS), a principles-based set of standards promulgated by the International Accounting Standards Board (IASB).

U.S. GAAP are the principles published by the Financial Accounting Standards Board (FASB), which is the governing body for accountants in the United States. The FASB was organized in 1973, and has worked since its inception “to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.”(Financial Accounting Standards Board Facts). The major international standard setter is the International Accounting Standards Board (IASB), which was founded in 2001, as the successor to the International Accounting Standards Committee (IASC). The IASC had been formed in London in 1973 to develop and sanction International Accounting Standards.

In October 2002, the FASB and the IASB issued a Memorandum of Understanding, which outlined the so-called “Norwalk Agreement”, announcing their intent to “(a) make their existing financial reporting standards fully compatible as soon as is practicable and (b) to

coordinate their future work programs to ensure that once achieved, compatibility is maintained” (Financial Accounting Standards Board Memorandum 1). Since its inception, the idea of the convergence of U.S. and International accounting standards into a set of universal standards has been a controversial, though inevitable, endeavor. The globalization of the business environment necessitates a single set of standards to enhance comparability among companies worldwide; however, the process leading to that single set of standards is filled with questions and conflicting opinions about the means by which the end should be reached.

In September 2008, the FASB and the IASB updated their Memorandum of Understanding to comment on the current status of the convergence process, which includes the SEC’s removal of its requirement for non-U.S. companies following IFRS to reconcile their statements to U.S. GAAP. Also, according to the Progress Report, “At their joint meeting in April 2008, the Boards again affirmed their commitment to developing common, high quality standards, and agreed on a pathway for completing the MoU projects, including projected completion dates” (Financial Accounting Standards Board Updated 1). The document also included specific short-term convergence objectives and major joint projects currently being undertaken. Additionally, the Progress Report laid forth some projected dates of completion. The FASB and IASB continue with the joint projects, hoping to develop milestones and priorities for these projects by 2011 (2).

The convergence process is sure to take a number of years to complete, but both the IASB and FASB seem to favor completion of the process sooner rather than later. The Securities and Exchange Commission is also lending its support to the process. In a press release dated

August 27, 2008, the SEC announced the development of a 'roadmap' that would potentially lead to the use of IFRS by U.S.-based companies as early as 2014.

Valuation of Plant Assets: Historical Cost vs. Fair Value

The debate surrounding which amount to use when accounting for plant assets has been going on for some time. This discussion has become more prominent lately with the increased discussion of a worldwide set of accounting standards, as it is one of the most prominent differences between U.S. and International Standards. Significant support exists for each measure, and both sides make valid arguments. While advocates of each approach deem their model most appropriate, the reality is that advantages and disadvantages exist for each method.

In their paper titled "The Quality of Fair Value Measures for Property, Plant and Equipment", Don Herrmann and his co-authors present an interesting case for the use of fair value as the measure of items of property, plant and equipment. In framing their assertions, the authors discuss SFAC No. 2, which lays out the qualitative characteristics of accounting information (Herrmann 3). One such quality is relevance, which encompasses three primary characteristics: predictive value, feedback value and timeliness (9). In discussing predictive value, or the degree to which information will correctly forecast the outcome of certain events, the authors examined several studies and determined that the revaluation approach has a greater predictive value than historical cost measures (9). The authors argue further that "fair values are clearly preferable to historical costs in estimating an acquisition price or liquidating the assets of the firm" (10). In more accurately estimating acquisition prices of plant assets, fair values

possess a superior feedback value. According to the paper, timeliness is defined in SFAC No. 2 as “having information available to a decision maker before it loses its capacity to influence decisions” (12). Over time, book values under historical cost and fair value diverge, and the capacity of historical cost to influence decisions is diminished (12). This assertion implies that fair value has a higher degree of timeliness than historical cost.

Another characteristic of accounting information the authors evaluate in their mission to support fair value is reliability, which is characterized by verifiability, neutrality, and representational faithfulness (Herrmann 13). The authors concede that arguments in favor of historical cost are usually based upon the argument that this amount is more easily verifiable. However, they contend that for some assets, like self-constructed assets and assets acquired in bulk through business transactions, the historical cost is not easily verified. Additionally, several situations are currently allowed under GAAP in which fair value is used. For example, when plant assets are impaired, they are written down to fair value. Fair value is also used to record plant assets of discontinued operations, donated plant assets, and plant assets purchased in bundles (14).

Neutrality suggests that there should be no bias in reported information. The authors argue that historical cost introduces into its calculations a “conservative bias”. The authors again cite SFAC 2, which supports this argument by noting that the FASB acknowledges that “conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits...because conservatism has long been identified with the

idea that deliberate understatement is a virtue” (Herrmann 15). This statement, according to the authors, illustrates that conservatism should not be a valid basis to support the continued use of historical costs for the valuation of items of property, plant and equipment (16). Representational faithfulness indicates that there should be some agreement between a value or measure and the event that it represents. It is clear that historical cost is subject to less manipulation than fair values measures, which is why historical cost is considered a more faithful representation of property, plant and equipment. However, the authors contend that earnings can be managed under the historical cost method as well; if such behavior takes place, then the argument for historical cost accounting loses some value (18).

Continuing through the list of accounting information concepts that seem to support the use of fair value, the authors discuss comparability, which is the attribute of information that enables users to see the similarities and differences in data. According to the authors, historical cost can actually hinder the comparability of assets by failing to accurately identify similarities and differences among them (Herrmann18). The point is best summed up in the following statement: “By allowing, rather than requiring revaluations, comparability may be reduced... It is more difficult to identify similarities in and differences between firms’ property, plant, and equipment when such assets are reported using different valuation methods” (19).

Finally, the authors assert, the characteristic of consistency favors the use of fair value in measuring items of property, plant, and equipment. Fair value accounting reports all transactions, both past and present, using the fair value approach. Historical cost, on the other

hand, leads to reporting some (past) transactions at historical amounts and other (current) transactions at fair value (Herrmann 20). Overall, the paper suggests that based on the characteristics of accounting information laid out in SFAC 2, fair values measures are superior to historical cost in accounting for items of property, plant and equipment.

Presenting an opposing view, Kevin Thompson explores the historical cost approach in his article “Advantages and Disadvantages of Historical Cost Accounting” (Thompson). He begins by explaining some common criticisms of the historical cost method, including the argument that this method ignores the fact that the current market value of an asset may be higher or lower than historical cost makes it appear. Additionally, he notes that critics point out flaws in the method during times of inflation (Thompson). Despite its faults, Thompson argues, historical cost is better than any of the alternatives. One of the main reasons the accounting profession presently favors historical cost is because these costs are less open to discretion and possible manipulation. He notes that, “Any other basis for recording transactions would be subjective, i.e. the amount in which the transaction will be recorded would be dependent on individual point of view and is bound to differ with different people” (Thompson). Finally, Thompson points out that historical cost provides more accurate and reliable information, as the amounts are based on actual, as opposed to hypothetical, transactions. He sums up his findings in the following statement: “No other method of accounting can provide exact information at a glance on the change in trends in the company's working like the historical cost method” (Thompson).

It is not just deciding the approach to implement when accounting for fixed assets that is controversial. Even the term “fair value” inspires debate. U.S. Standards and IFRS have different approaches to defining the term and determining its amount. This matter was one topic of the IASB’s Discussion Paper issued in November 2006. The paper describes the differences in the definition of fair value, first by summarizing SFAS 157, which defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Alternatively, according to the document, IFRS defines fair value as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction” (Discussion Paper 8). According to the paper, there are three main differences between the SFAS 157 and IAS 16 definition of fair value: 1. SFAS 157 explicitly defines fair value as the selling price, whereas IAS 16 could be either the selling price or the replacement cost; 2. SFAS 157 refers to ‘market participants’, while IAS 16 refers to ‘knowledgeable, willing parties in an arm’s length transaction’; and 3. SFAS 157 defines the fair value of liabilities with the notion that the liability is transferred, not settled. The definition of fair value presented by the IASB refers to “the amount at which a liability could be settled between knowledgeable, willing parties in an arm’s length transaction.” (10). Currently, the IASB is receiving comments in response to the Discussion Paper. An exposure draft of an IFRS on fair value measurement is expected in 2009 or 2010.

Despite the ongoing discussions revolving around the valuation of plant assets, U.S. standards require the valuation of long-term assets at their historical cost. The application of a

revalued amount, whether based on market price or some other measure, is prohibited.

According to APB Opinion No. 6, "... property, plant, and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity" (APB Opinion 6. 17.1). The complexities of the revaluation approach are apparently too vague and open to discretion to be acceptable.

Historical cost is the more straightforward approach, as it requires relatively few estimates or assumptions, and is based primarily on concrete data. While the historical cost approach's data is less open to discretion, the amounts the approach applies to assets are not necessarily the most current. This is why IFRS permits the use of either the historical cost or revaluation approach to account for property, plant and equipment throughout the assets' useful lives.

IAS 16 Property Plant and Equipment

As was previously discussed, U.S. and international standards differ in their approaches to account for plant assets. The international standard that provides guidance on property, plant and equipment is IAS 16. The Standard was originally issued in 1982 and has been amended three times. The current version was revised in 2003, has an effective date of January 1, 2005, and was updated as part of the IASB's Improvements Project ("Summaries").

The objective of IAS 16 is "to prescribe the accounting treatment for property plant and equipment." The principal issues in accounting for these assets include recognizing the assets and determining their carrying amounts, depreciation charges and impairment losses related to the assets. The Standard's scope states that it "shall be applied in accounting for property, plant

and equipment except when another Standard requires or permits a different accounting treatment.” IAS paragraph 7 outlines the recognition of the historical cost of Property, Plant and Equipment. According to the Standard, the historical cost of a fixed asset is recognized if two criteria are met: “1.It is probable that future economic benefits associated with the item will flow to the entity; and 2.The cost of the item can be measured reliably” (IAS 16.7).

After concluding that an item of property, plant and equipment should be recognized, a company must determine how to accurately measure the value of the asset throughout its useful life. According to IAS 16, paragraph 15, property, plant and equipment should be carried at historical cost. The elements of cost include the purchase price, costs directly attributable bringing the asset to the location, and the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. Directly attributable costs include costs of employee benefits arising directly from the construction or acquisition of the item of property, plant and equipment; costs of site preparation; initial delivery and handling costs; installation and assembly costs; costs of testing whether the asset is functioning properly (after deducting the proceeds from selling any items produced while bringing the asset to that location and condition) and professional fees (IAS 16.16-17).

After establishing an asset’s cost, an entity must use either the cost model or the revaluation model. As previously mentioned, the cost model is fairly straightforward. It simply states that property, plant and equipment should be carried at an amount equal to cost less accumulated depreciation and accumulated impairment losses (IAS 16.30). The revaluation

model is more complex and can only be used when the fair value of the asset can be determined with reasonable reliability. According to this model, property, plant and equipment should be carried at a “revalued amount” equal to the fair value of the asset at the revaluation date less accumulated depreciation and impairment losses after revaluation. Revaluations should occur fairly regularly to ensure that the carrying amount does not materially differ from the fair value at the balance sheet date (IAS 16.31).

When using the revaluation model, companies must also determine the amount of accumulated depreciation. The depreciation must then be treated in one of two ways: It could be restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals the revaluation amount. Alternatively, accumulated depreciation could be eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset (IAS 16.35).

As an example, assume that Tennessee Company purchased a piece of equipment at January 1, Year 1 for \$100,000. The equipment is expected to have a useful life of ten years and no residual value. The asset is accounted for using the revaluation model and is revalued every two years. At the end of Year 2, the equipment is appraised at a fair value of \$85,000.

The Gross Carrying Amount approach works in two steps: first, the accumulated depreciation is written off; then, the equipment is adjusted to the revalued amount.

The journal entries to record the change in the equipment's value are as follows:

To eliminate accumulated depreciation:

Accumulated Depreciation	20,000	
Equipment		20,000

To adjust the building to a revalued amount:

Equipment	5,000	
(85,000-80,000)		
Revaluation Surplus(SE)		5,000

The proportional method uses the amounts calculated below to write up the asset's value based on the proportional change in the asset's carrying amount.

Calculation of the Proportional Method:

	Cost before Revaluation:		Revalued Amount:
Equipment	100,000	x 85,000/80,000	106,250
Less: Accumulated Depreciation			
(\$100,000/10 * 2 years)	<u>20,000</u>	x 85,000/80,000	<u>21,250</u>
Carrying Amount	<u>80,000</u>	x 85,000/80,000	<u>85,000</u>

The journal entries to record the proportional change in the asset's value based on its appraised value are as follows:

Equipment	6,250	
(106,250-100,000)		
Accumulated Depreciation		1,250
(21,250-20,000)		
Revaluation Surplus (SE)		5,000
(85,000-80,000)		

To calculate the revalued equipment and depreciation amounts, the cost before revaluation and original accumulated depreciation is multiplied by an indexed amount, which is the proportion of the revalued amount to the original carrying amount. The accounts are then adjusted to reflect the changes based on the revalued amount. The excess of the original carrying amount to the revalued amount is credited to an equity account titled 'Revaluation Surplus', which is described below.

According to IAS 16, if the revaluation causes an increase in the carrying amount of the asset, the increase should be credited directly to stockholders' equity under the title 'Revaluation Surplus', which is the case presented in the example above. However, the increase should be recognized in an income statement account such as profit or loss if it reverses a revaluation decrease of the same asset previously recognized in profit or loss (IAS 16.39). If the revaluation, however, causes a decrease in the carrying amount of the asset, the decrease should be recognized as profit or loss. If there is a credit balance in the revaluation surplus, then the amount should be debited to stockholder's equity (IAS 16.39). Examples will again clarify the complexities of the process.

Using the previous scenario, recall that Tennessee Company purchased a piece of equipment for \$100,000. The equipment is expected to have a useful life of ten years and no residual value. The equipment is accounted for using the revaluation model and is revalued every two years. At the end of Year 2, the equipment is appraised at a value of \$85,000.

The calculation of the equipment's current book value is detailed below:

Original Book Value:	100,000
Less: Accumulated Depreciation	<u>(20,000)</u>
Book Value, end of Year 2:	<u>80,000</u>

Using the Gross Carrying Amount approach, the journal entries to record the change in the equipment's value are as follows:

<i>To eliminate accumulated depreciation:</i>		
Accumulated Depreciation	20,000	
Equipment		20,000
<i>To adjust the building to a revalued amount:</i>		
Equipment	5,000	
(85,000-80,000)		
Revaluation Surplus(SE)		5,000

Two more years have passed. At the end of Year 4, the equipment is re-appraised at a fair value of \$55,000. According to IAS 16, Tennessee Company must recognize the decrease in the asset's carrying amount first by removing any previous Revaluation Surplus, then by debiting a loss account (IAS 16.40).

Book Value, end of Year 2:	85,000
Less: Accumulated Depreciation	<u>(21,250)</u>
(85,000/8 year useful life * 2 years)	
Book Value, end of Year 4:	<u>63,750</u>

The journal entry to record this decrease in the equipment's value is as follows:

To eliminate accumulated depreciation:

Accumulated Depreciation	21,250	
Equipment		21,250

To adjust the building to a revalued amount:

Loss on Revaluation (IS)	3,750	
Revaluation Surplus (SE)	5,000	
Equipment		8,750

Two years later, at the end of Year 6, the asset is appraised at \$45,000. The previous carrying amount was \$55,000, so the accumulated depreciation would be \$18,333 ($\$55,000/6 * 2$ years). The asset's new carrying amount is \$36,667 ($\$55,000 - \$18,333$). Therefore, Tennessee Company now recognizes an \$8,333 increase in the asset's value. According to IAS 16, the Company must first allocate some of this amount to an income statement account "to the extent that it reverses a revaluation decrease of the same amount previously recognized in profit or loss" (IAS 16.39). The excess will be credited to stockholder's equity.

Equipment	8,333	
Profit on Revaluation (IS)	3,750	
Revaluation Surplus (SE)	4,583	

There are certainly other issues that surface with the application of the revaluation model, but the most common differences have been explained above. With all of the differences in the cost and revaluation models, many may feel uncomfortable with the approach because of the frequent changes in profit and equity accounts that go along with the re-appraisal of assets.

However, as the revaluation approach becomes better understood, more companies are likely to report their plant assets at fair value.

Revaluation Approach in Practice: ING Group N.V.

Since the European Union's adoption of IFRS, many companies have begun applying the revaluation approach allowed for in IAS 16 in valuing their plant assets. Global financial services firm ING Group N.V., based in the Netherlands, began applying the fair value approach to its "Property in Own Use" in 2005. In examining the company's most recent financial statements, readers might gain a better understanding of the application of the revaluation approach as discussed in IAS 16. Selected information from the company's 2007 Annual Report is attached in Appendix A.

The annual report begins with the auditor's report to shareholders and management. ING's 2007 audit report states that the audit was conducted in accordance with the Public Company Accounting Oversight Board (PCAOB) of the United States. The auditors, Ernst & Young Accountants in Amsterdam, issued an unqualified opinion, indicating that the statements were fair and there were no material misstatements. According to the auditors, the statements were presented in conformity with International Financial Reporting Standards as adopted by the European Union (ING Annual Report 240).

ING's 2007 Consolidated Balance Sheet included Property and Equipment as a line item, with a total of €6.2 billion. The Balance Sheet directs users to Note 8. Before exploring Note 8,

it is important to examine Section 2.1.1 of the financial statements, which discusses the critical accounting policies implemented by the company during the development of the statements.

According to this section, “property in own use” is stated at fair value as of the balance sheet date. The fair value is determined by regular appraisals by “independent qualified valuers”. The company summarizes its interpretation and implementation of IAS 16.39 in its Accounting Policies for the Consolidated Balance Sheet and Profit and Loss (ING Annual Report 101). After considering the company’s accounting policies, financial statement readers continue exploring the fixed assets by analyzing Note 8 to ING’s consolidated financial statements, which further analyzes the line item “Property and equipment” as listed on the company’s balance sheet. This note contains a breakdown of the aggregate “property and equipment” amount into various components, including the revaluation amount. In disclosing the changes in the property in own use account, the company recorded a revaluation in the “Changes in property and equipment” as a decrease of €60.0 million in 2007. This “revaluation surplus” amount is further examined when it is calculated and is disclosed as follows (ING Annual Report 119):

Revaluation surplus:

2007

Opening balance	693
Revaluation in year	19
Released in year	<u>(79)</u>
Closing balance	<u>633</u>

As this calculation shows, the difference between the closing balance of €633.0 million in 2007 and €693.0 million in 2006 is equal to the €60.0 million, which is accounted for by a revaluation in 2007 of €19.0 million and €79.0 million released in 2007. This amount also confirms the decrease of €60.0 million disclosed earlier in Note 8.

ING's decision to implement the revaluation approach has caused changes in its financial statements. While the financial effects of this decision are still being determined, the company's financial statements demonstrate the importance of adequate disclosure. Examining the statements as well as the notes helps explain the practical application of the very complex reporting and disclosure requirements of the revaluation approach.

Conclusions

Though the cost model has historically been considered a more accurate approach for valuing fixed assets, the revaluation model, based upon some measure of fair value, appears to more accurately reflect the current value of a company's assets than historical cost. This paper presented arguments that using fair value for plant assets is consistent with the qualities of useful accounting information, as presented in SFAC 2. Additionally, a discussion of IAS 16 outlined many of the details of the revaluation approach, providing several examples. Finally, examining the financial statements of a company that applies the revaluation approach depicted how the approach is applied in practice. The revaluation approach as presented in IAS 16 is likely to become more common with the upcoming convergence of U.S. and International accounting

standards into a single worldwide authority. Given this probable merger, it is important for current and future practitioners to understand the specifics of the revaluation model.

WORKS CITED

Accounting Principles Board. APB Opinion No. 6: Status of Accounting Research Bulletins.

1965.

Financial Accounting Standards Board. Facts About FASB. Norwalk, CT, 2007.

---. Memorandum of Understanding. 2002.

---. Updated Memorandum of Understanding. 2008.

Herrmann, Don, Shahrokh Saudagagaran and Wayne B. Thomas. "The Quality of Fair Value

Measurement for Property, Plant and Equipment". 2005.

ING Group, N.V. 2007 Annual Report. 17 March 2008.

< http://www.ing.com/group/showdoc.jsp?docid=311528_EN&menopt=ivr|pub|007>

International Accounting Standards Board. 2006. Discussion Paper: *Fair Value Measurements*.

London: IASB

---. IAS 16: Property, Plant and Equipment. 31 May 2006.

"Summaries of International Financial Reporting Standards." IAS Plus. 2003. Deloitte Touche

Tomatsu. 1 Nov. 2008 <<http://www.iasplus.com/standard/ias16.htm>>.

Thompson, Kevin. "Advantages and Disadvantages of Historical cost Accounting". Associated

Content. 2007. 3 November 2008. <<http://www.associated>

[content.com/article/110085/advantages_and_disadvantages_of_historical.html?cat=3](http://www.associatedcontent.com/article/110085/advantages_and_disadvantages_of_historical.html?cat=3)>

Appendix A

Selected Data from ING Group N.V.'s 2007 Annual Report

2.3 Other information

Auditor's report

To the Shareholders, the Supervisory Board and the Executive Board of ING Groep N.V.

REPORT ON THE ANNUAL ACCOUNTS

We have audited the annual accounts 2007 of ING Groep N.V., Amsterdam (as set out on pages 88 to 239). The annual accounts consist of the consolidated annual accounts and the parent company annual accounts. The consolidated annual accounts comprise the consolidated balance sheet as at 31 December 2007, the profit and loss account, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes. The parent company annual accounts comprise the parent company balance sheet as at 31 December 2007, the parent company profit and loss account for the year then ended and the notes.

Management's responsibility

Management of the company is responsible for the preparation and fair presentation of the annual accounts in accordance with International Financial Reporting Standards as adopted by the European Union and with Part 9 of Book 2 of the Dutch Civil Code, and for the preparation of the report of the Executive Board in accordance with Part 9 of Book 2 of the Dutch Civil Code. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the annual accounts that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on the annual accounts based on our audit. We conducted our audit in accordance with Dutch law and the standards of the Public Company Accounting Oversight Board (United States). This law and these standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the annual accounts are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the annual accounts. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the annual accounts, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the annual accounts in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the annual accounts.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion with respect to the consolidated annual accounts

In our opinion, the consolidated annual accounts give a true and fair view of the financial position of ING Groep N.V. as at 31 December 2007, and of its result and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union and with Part 9 of Book 2 of the Dutch Civil Code.

Opinion with respect to the parent company annual accounts

In our opinion, the parent company annual accounts give a true and fair view of the financial position of ING Groep N.V. as at 31 December 2007, and of its result for the year then ended in accordance with Part 9 of Book 2 of the Dutch Civil Code.

REPORT ON OTHER LEGAL REQUIREMENTS

Pursuant to the legal requirement under 2:393 sub 5 part 4 of the Dutch Civil Code, we report, to the extent of our competence, that the report of the Executive Board is consistent with the annual accounts as required by 2:391 sub 4 of the Dutch Civil Code.

Amsterdam, 17 March 2008

For Ernst & Young Accountants

signed by C.B. Boogaart

2.1 Consolidated annual accounts

Consolidated balance sheet of ING Group as at 31 December

amounts in millions of euros	2007	2006
ASSETS		
Cash and balances with central banks 1	12,406	14,326
Amounts due from banks 2	48,875	39,868
Financial assets at fair value through profit and loss 3		
– trading assets	193,213	193,977
– investments for risk of policyholders	114,827	110,547
– non-trading derivatives	7,637	6,521
– designated as at fair value through profit and loss	11,453	6,425
Investments 4		
– available-for-sale	275,897	293,921
– held-to-maturity	16,753	17,660
Loans and advances to customers 5	552,964	474,437
Reinsurance contracts 17	5,874	6,529
Investments in associates 6	5,014	4,343
Real estate investments 7	4,829	6,974
Property and equipment 8	6,237	6,031
Intangible assets 9	5,740	3,522
Deferred acquisition costs 10	10,692	10,163
Other assets 11	40,099	31,063
Total assets	1,312,510	1,226,307
EQUITY		
Shareholders' equity (parent) 12	37,208	38,266
Minority interests	2,323	2,349
Total equity	39,531	41,215
LIABILITIES		
Preference shares 13	21	215
Subordinated loans 14	7,325	6,014
Debt securities in issue 15	66,995	78,133
Other borrowed funds 16	27,058	29,639
Insurance and investment contracts 17	265,712	268,683
Amounts due to banks 18	166,972	120,839
Customer deposits and other funds on deposit 19	525,216	496,660
Financial liabilities at fair value through profit and loss 20		
– trading liabilities	148,988	127,975
– non-trading derivatives	6,951	4,934
– designated as at fair value through profit and loss	13,882	13,702
Other liabilities 21	43,859	38,278
Total liabilities	1,272,979	1,185,092
Total equity and liabilities	1,312,510	1,226,307

References relate to the notes starting on page 110 which form an integral part of the consolidated annual accounts.

Investments in associates are initially recognised at cost and subsequently accounted for using the equity method of accounting.

The Group's investment in associates (net of any accumulated impairment loss) includes goodwill identified on acquisition. The Group's share of its associates' post-acquisition profits or losses is recognised in the profit and loss account, and its share of post-acquisition changes in reserves is recognised in equity. The cumulative post-acquisition changes are adjusted against the carrying amount of the investment. When the Group's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Unrealised gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Accounting policies of associates have been changed where necessary to ensure consistency with the policies adopted by the Group. The reporting dates of all material associates are consistent with the reporting date of the Group.

For interests in investment vehicles the existence of significant influence is determined taking into account both the Group's financial interests for own risk and its role as investment manager.

REAL ESTATE INVESTMENTS

Real estate investments are stated at fair value at the balance sheet date. Changes in the carrying amount resulting from revaluations are recorded in the profit and loss account. On disposal the difference between the sale proceeds and book value is recognised in the profit and loss account.

Fair value of real estate investments is based on regular appraisals by independent qualified valuers. Each year a valuation is made, either by an independent valuer or internally, of every property. Indexation is used when a property is valued internally. The index is based on the results of the independent valuations carried out in that period. Market transactions, and disposals made by the Group, are monitored as part of the procedures to back test the indexation methodology. All properties are valued independently at least every 5 years.

PROPERTY AND EQUIPMENT

Property in own use

Land and buildings held for own use are stated at fair value at the balance sheet date. Increases in the carrying amount arising on revaluation of land and buildings held for own use are credited to the revaluation reserve in shareholders' equity. Decreases that offset previous increases of the same asset are charged against the revaluation reserve directly in equity; all other decreases are charged to the profit and loss account. Increases that reverse a revaluation decrease on the same asset previously recognised in net profit are recognised in the profit and loss account. Depreciation is recognised based on the fair value and the estimated useful life (in general 20–50 years). Depreciation is calculated on a straight-line basis. On disposal the related revaluation reserve is transferred to retained earnings.

The fair values of land and buildings are based on regular appraisals by independent qualified valuers. Subsequent expenditure is included in the assets carrying amount when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably.

Property under construction

Land and buildings under construction (including real estate investments) are stated at the directly attributable purchase and construction costs incurred up to the balance sheet date plus borrowing costs incurred during construction and the Group's own development and supervision expenses, where necessary, less impairment losses.

Property held for sale

Property held for sale comprises properties obtained from foreclosures and property developed for sale for which there is no specifically negotiated contract. These properties are stated at the lower of cost and net realisable value. Cost includes borrowing costs. Net realisable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses. Where the net realisable value is lower than the carrying amount, the impairment is recorded in the profit and loss account.

Property under development for third parties

Property under development where there is not yet a specifically negotiated contract is measured at direct construction cost incurred up to the balance sheet date, including borrowing costs incurred during construction and the Group's own directly attributable development and supervision expenses less any impairment losses. Profit is recognised using the completed contract method (on completion date of the property).

Property under development where there is a specifically negotiated contract is valued using the percentage of completion method (pro rata profit recognition).

2.1 Consolidated annual accounts

Notes to the consolidated balance sheet of ING Group (continued)

In 2007 Changes in composition of the group relates mainly to the deconsolidation of Real estate funds as a result of the reduction of ING's shareholding in these funds.

Real estate investments by insurance and banking operations

	2007	2006
Insurance operations	1,302	3,310
Banking operations	3,527	3,664
	4,829	6,974

The total amount of rental income recognised in the profit and loss account for the year ended 31 December 2007 was EUR 402 million (2006: EUR 434 million). The total amount of contingent rent recognised in the profit and loss account for the year ended 31 December 2007 was EUR 14 million (2006: EUR 14 million).

The total amount of direct operating expenses (including repairs and maintenance) arising from Real estate investments that generated rental income for the year ended 31 December 2007 was EUR 64 million (2006: EUR 165 million). The total amount of direct operating expenses (including repairs and maintenance) arising from Real estate investments that did not generate rental income for the year ended 31 December 2007 was EUR 20 million (2006: EUR 32 million).

Appraisal of real estate investments during the last five years by independently qualified valuers (in percentages)

year of appraisal	
2007	64
2006	36
2005	0
2004	0
2003	0
	100

8 PROPERTY AND EQUIPMENT**Property and equipment by type**

	2007	2006
Property in own use	2,069	2,034
Equipment	1,270	1,312
Assets under operating leases	2,898	2,685
	6,237	6,031

Property in own use by insurance and banking operations

	2007	2006
Insurance operations	599	694
Banking operations	1,470	1,340
	2,069	2,034

Changes in property in own use

	2007	2006
Opening balance	2,034	2,271
Additions	85	68
Changes in the composition of the group	29	-14
Transfers to and from Real estate investments	60	-44
Transfers to and from Other assets	59	-4
Depreciation	-39	-64
Revaluations	-60	76
Reversal of impairments	14	4
Disposals	-84	-221
Exchange rate differences	-29	-38
Closing balance	2,069	2,034
Gross carrying amount as at 31 December	2,943	2,883
Accumulated depreciation as at 31 December	-708	-669
Accumulated impairments as at 31 December	-166	-180
Net book value	2,069	2,034
Revaluation surplus		
Opening balance	693	612
Revaluation in year	19	32
Released in year	-79	-1
Closing balance	633	643

The cost or purchase price amounted to EUR 2,310 million (2006: EUR 2,190 million). Cost less accumulated depreciation would have been EUR 1,602 million (2006: EUR 1,521 million).

Appraisal of property in own use during the last five years by independently qualified valuers (in percentages)

year of appraisal	
2007	39
2006	19
2005	26
2004	4
2003	12
	100

Changes in equipment

	Data processing equipment		Fixtures and fittings and other equipment			
	2007	2006	2007	2006	2007	2006
Opening balance	283	314	1,029	1,002	1,312	1,316
Additions	177	157	309	343	486	500
Changes in the composition of the group	10	-7	16	-1	26	-8
Disposals	-24	-9	-44	-63	-68	-72
Depreciation	-164	-177	-216	-222	-380	-399
Impairments	-1		-1	-1	-2	-1
Exchange rate differences	-3	-6	-17	-26	-20	-32
Other changes	3	11	-87	-3	-84	8
Closing balance	281	283	989	1,029	1,270	1,312
Gross carrying amount as at 31 December	1,763	1,499	2,950	2,729	4,713	4,228
Accumulated depreciation as at 31 December	-1,481	-1,216	-1,959	-1,699	-3,440	-2,915
Accumulated impairments as at 31 December	-1		-2	-1	-3	-1
Net book value	281	283	989	1,029	1,270	1,312

120

2.1 Consolidated annual accounts

Notes to the consolidated balance sheet of ING Group (continued)

Changes in assets under operating leases						
	2007	Cars 2006	Other leased-out assets		2007	Total 2006
Opening balance	2,671	2,116	14	54	2,685	2,170
Additions	1,396	1,146	2	18	1,398	1,164
Changes in the composition of the group		417		-46		371
Disposals	-417	-400		-2	-417	-402
Depreciation	-720	-617	-4	-10	-724	-627
Exchange rate differences	-44	9			-44	9
Closing balance	2,886	2,671	12	14	2,898	2,685
Gross carrying amount as at 31 December	5,177	3,938	70	39	5,247	3,977
Accumulated depreciation as at 31 December	-2,291	-1,267	-58	-25	-2,349	-1,292
Net book value	2,886	2,671	12	14	2,898	2,685

Depreciation of assets under operating leases is included in the profit and loss account in other income as a deduction from operating lease income.

No individual operating lease has terms and conditions that materially affect the amount, timing or certainty of the consolidated cash flows of the Group.

The Group leases assets to third parties under operating leases as lessor. The future minimum lease payments to be received under non-cancellable operating leases are as follows:

Future minimum lease payments by maturity		
	2007	2006
Within 1 year	1,048	926
More than 1 year but less than 5 years	1,844	1,754
More than 5 years	6	5
	2,898	2,685