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CHARTERED ACCOUNTANTS

TT235 Tangible Fixed Assets (PPE) & Investment Properties (inc. Deferred Tax)

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As part one of the six key areas of FRS102, this week we bring you the significant ways the new Standard will impact on how you present tangible fixed assets, investment properties and the potential effect on deferred tax.

Tangible fixed assets

The technical bit:

Tangible fixed assets, or should we say Property Plant and Equipment, as it is now termed within the standard, refers to, for example, land, buildings, fixtures, fittings, office equipment, machinery, computers, motor vehicles etc. Biological (agricultural) assets and that relating to minerals, being classed as specialised activities, are covered elsewhere within the standard and outside of this TT.

In general, the line adopted by FRS102 is very akin to current practice, in that such assets are initially measured at cost, being purchase price or cost of production. There is explicit mention that land and buildings are separable assets and should be accounted as such, even if they are acquired together. Depreciation should still be provided to reflect the consumption of assets during a period and charged to the P&L.

Major spare parts, servicing equipment and replacement parts that may have been expensed previously, are now specifically covered and in most instances should be capitalised and only expensed as consumed. This will have a real effect on the distributable reserves.

Options and opportunities:

Assets are usually depreciated over a period not more than 50 years, otherwise an annual impairment review is needed. This requirement is no longer present and so could potentially allow for longer estimates of useful lives, and thus the spreading of costs, so long as justified.

You may still choose to state assets of the same class at revaluation, which with appreciating assets, gives the opportunity to strengthen the balance sheet. What determines a class is defined as “those that have a similar nature, function or use in the business”, so potentially allows more flexibility than previously available. Assets that are appreciating in nature, may be deemed of a class and revalued accordingly, without the need to revalue all assets that may have fallen to be classed together under the old accounting standards. For example office and industrial buildings may be deemed of a different class.

Such revalued assets are no longer required to observe a stringent 5 year revaluation cycle (usually full valuation every 5 years with interim valuations in year 3), nor are there requirements for valuations to be performed every year. This may be welcome news where the costs of revaluation are relatively high. Revaluations should simply be carried out with sufficient regularity to ensure the carrying amounts do not materially differ from its fair (market) value.

The Standard advises that valuations are “normally undertaken by professionally qualified valuers” but no longer requires this to be an external, independent valuer. This can give the opportunity for internal valuation by those with sufficient knowledge of the market, although this fact would need to be stated in the accounts.

As with the previous Standards, gains arising from the revaluation of such assets are recognised under Other comprehensive income, rather than the P&L, and taken to equity i.e. a revaluation reserve. Decreases in value are taken to the P&L where the decrease is in excess of any previously recognised gains, which in effect is when the asset is revalued below cost. This distinction assists in assessing distributable reserves.

Transition:

On transition to FRS102, an entity may choose to take fair value or a previous revaluation amount of an asset to be the deemed cost. One implication is that for revalued assets you could choose to ‘bank’ any previous gains without the need for revaluation going forwards. The assets will need to be depreciated thereafter, but as mentioned the effect of a potentially longer depreciation period may mean that, the year-on-year effect on the results presented may be minimal.

Tax effect:

There still exists a distinction between depreciation within the accounts and tax capital allowances giving rise to deferred tax assets and liabilities and so is not expected to alter tax charges significantly from that at present. The potential change in recognition of major spare parts, servicing equipment and replacement parts may lead to a comparatively higher tax charge in the short term.

Revaluations are still not recognised for tax purposes and will fall to be taxable when the assets are disposed of.

Investment properties

The technical bit:

The changes brought about by FRS102 covering investment properties are some of the most profound in terms of the effect on reportable gains and losses and balance sheet values.

Under current accounting principles, such investments are defined as “held not for consumption in the business operations but as investments, the disposal of which would not materially affect the manufacturing or trading operations of the enterprise”.

Such assets are required to be stated at open market value, with any changes going to a separate revaluation reserve.

FRS102 still requires such assets to be stated at fair value, but the big change here, and distinct to property, plant and equipment, is that changes in values should go to the profit and loss account. This has the potential to materially affect the reported retained profit of the entity in a period.

As any gains are not actually realised until sold they are not distributable. Care must be taken therefore to ensure a note is kept of that taken to the profit and loss account, in deciding on dividends. In practice it may be beneficial to still show any unrealised gains distinct in a revaluation reserve rather than the profit and loss reserve.

Another significant change could be in group situations. Properties used by other group companies would, under current Standards, be classified as tangible fixed assets, subject to depreciation. Under FRS102 there is no distinction between properties let out to other group entities. Land and buildings that may have been held under fixed assets will going forwards be required to be classified as investment properties with the requirement to be carried at fair value. Companies that hold properties for genuine commercial reasons outside of trading companies, may find themselves having to now show the assets at “fair value”, dependent on careful consideration of the circumstances, which could determine property to be trading in nature rather than investment.

Where it is deemed that investment property cannot be measured reliably without undue cost or effort on an on-going basis, this will be accounted for as property plant and equipment and carried at costs with deprecation etc. Careful consideration will be needed in determining whether this applies.

Tax effect:

The upwards revaluation of assets, including property plant and equipment and investment property did not generally result in a deferred tax liability under current UK GAAP, however under FRS102 it is required. This is a major change and for companies that have had polices of revaluation in the past they will have a potentially significant reduction to the balance sheet value.

Where covenants are present, careful consideration of the effect on profits and asset values on key ratios such as interest cover, gearing and dividend cover will need to be made.

Speak to a Barnes Roffe partner today for a tailored review of how FRS 102 may affect you, and how we can help manage your tax and other important consequences of the standard.