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Accounting Alert

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In this issue

We have devoted this issue to the new financial reporting standard on property, plant and equipment. For many entities the impact of the new standard will be minimal, however those entities with infrastructure assets, other complex assets or heritage assets, and charitable organisations or other entities which receive donated or subsidised assets, may find some significant work is required to comply with the new requirements. Entities which revalue their assets will also need to familiarise themselves with the new requirements.

New Financial Reporting Standard - FRS-3: Property, Plant and Equipment

The long awaited standard on accounting for property, plant and equipment has been released. As expected, it brings infrastructure assets and heritage assets within its scope and requires compliance with the depreciation and subsequent expenditure rules for these assets. Other significant changes include the mandatory capitalisation of borrowing costs and the requirement to record donated and subsidised assets at their fair value, with the donation or subsidy being recorded as revenue. The basis for revaluation has changed from an existing use basis to a fair value approach and there is more guidance on valuations, particularly in relation to the determination of depreciated replacement cost.

The standard replaces *SSAP-3: Accounting for Depreciation* and *SSAP-28: Accounting for Fixed Assets* and is applicable for accounting periods ending on or after **31 March 2002.**

Scope

FRS-3 does not deal with accounting for:

- self-generating and regenerating assets such as forests and livestock;
- expenditure on mineral rights, the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative natural resources; or
- investment properties or properties intended for sale.

Each of these is the subject of another current or intended financial reporting standard.

The standard specifically applies to items of property, plant and equipment which are the subject of finance leases. It also specifically applies to **infrastructure assets** and to **heritage assets**, where these meet the definition of "property, plant and equipment".

Main Features of the Standard

The requirements of FRS-3 are similar to those contained under SSAPs 3 and 28. Items of property, plant and equipment must be recorded at cost (including all the costs directly attributable to bringing the item to working condition for its intended use), must be depreciated (except for land) and should be reviewed for impairment. Subsequent expenditure on an asset may only be capitalised if the economic benefits to be derived from the asset are increased. The rules for recognising revaluations are also similar to those in SSAP-28 however there are some significant changes. We outline these as follows:

Significant changes from SSAP-3 and SSAP-28:

	SSAP-3/SSAP-28	FRS-3
Initial Cost		
Component accounting	Silent	Specifically requires that where the components of an item of PPE have different useful lives or provide benefit to the entity in different patterns, thus requiring different depreciation rates and methods, the cost is allocated to its components and each component is accounted for separately.
Capitalisation of Borrowing Costs	Permitted	**Mandatory** for directly attributable costs unless the entity qualifies for differential reporting (then permissible). Capitalisation must not exceed amount of borrowing costs incurred during the period.
Donated or subsidised items	Silent	Recognise asset at **fair value** - amount of donation, subsidy or compensation treated as **revenue.**
Compensation received in respect of the impairment or loss of items	Similar to FRS-3	*Lost/Destroyed Asset* Record a disposal for the lost asset, recognise compensation received as revenue, and record any replacement asset at cost. *Damaged Asset* Record impairment in carrying value of damaged asset, recognise compensation as revenue, and review subsequent expenditure rules re repair of the asset.
Subsequent Expenditure		
Safety and environmental expenditure	Silent	Permits capitalisation if expenditure was **necessarily incurred** to realise the future economic benefits embodied in the asset **and** if it would have been capitalised had the expenditure been incurred at acquisition.
Revaluations		
Basis	'Market value for the existing use'	**'Fair Value'**. Refer below.
Specialised assets	Silent	Optimised depreciated replacement cost where there is no market based evidence.
Disposal costs	Estimate of disposal costs required to be deducted in determining net current value	Not deducted.
Frequency	Maximum period between valuations - 3 years	Must be sufficient regularity so that PPE is stated at a valuation that is not materially different from its fair value. Maximum period between valuations - 5 years.
Use of independent qualified valuer	Required	Required, however, exemption for valuations of plant and equipment where there is an active market or readily available price indices that establish the item's fair value with reasonable reliability.
Change in Measurement Base	Not permitted. Once an entity undertakes revaluations under the standard, it is required to keep revaluing the relevant classes of assets	Permits an entity to **stop revaluing** in certain circumstances. Entity not required to restate carrying value to depreciated historical cost basis (has the choice). Specific disclosures of change and previous changes required. Treated as a change in accounting policy.
Impairment	Writedown required if 'permanent diminution in the value of an asset'	Writedown required whether impairment permanent or temporary.
Depreciation		
Annual review of method and remaining useful life	Silent	Mandatory to ensure both remain appropriate. Residual values are only revised for changes in prices when the asset itself is revalued.

*Under a **fair value** approach, the asset would be valued by reference to its 'highest and best use', ie **the way the asset itself could be used.***

Infrastructure assets

Entities with infrastructure assets are specifically required to account for these in accordance with the standard. The long run average renewals approach (LRARA) to accounting for infrastructure assets is no longer permitted. Infrastructure assets must be depreciated and the treatment of subsequent expenditure on these assets must conform to the guidance in the standard. The requirements to allocate costs to component parts of assets based on their useful lives is specifically included to enable entities with infrastructure and other complex assets to comply with the requirements of the standard.

Revaluations - change of basis and additional guidance

The basis for revaluation has changed from SSAP-28 to FRS-3. SSAP-28 requires the revaluation to be on a 'market value for the existing use' basis. FRS-3 requires revaluations to be on a 'fair value' basis. The difference between the two approaches depends on how the asset is viewed. Adopting an **existing use basis** for the valuation, the asset would be revalued based on **the way the asset is currently used by the entity**. A higher alternative use value would be ignored. Under a **fair value** approach, the asset would be valued by reference to its 'highest and best use', ie **the way the asset itself could be used**. This is the most probable use of the asset that is physically possible, appropriately justified, legally permissible, financially feasible and which results in the highest value.

By way of example, the fair value of a university campus in the middle of the central business district (ie as prime commercial property) may be quite different to a value determined under an existing use basis (ie as a university).

There is more guidance in FRS-3 on determining a valuation, and particularly determining a valuation based on depreciated replacement cost. The Financial Reporting Standards Board worked closely with the Standards Board of the New Zealand Property Institute in determining the guidance in this area to ensure that the requirements of the standard could be operationalised by valuers and to ensure that valuations would be relevant, reliable and consistent.

Depreciated replacement cost

Depreciated replacement cost is only permitted to be used where the fair value cannot be determined using market-based evidence (ie for specialised assets). In determining depreciated replacement cost, any **land component is valued at fair value**. The gross replacement cost is also **optimised** for **obsolescence** and **relevant surplus capacity**. A significant amount of guidance is included in the standard on determining the appropriate levels of optimisation.

An estimate of attributable borrowing costs must also be included in the calculation of depreciated replacement cost. This would be determined based on an industry average debt/equity ratio and by applying an industry average cost of debt.

A number of entities have been using optimised deprival value (ODV) for valuing their specialised assets. ODV is the lower of depreciated replacement cost and economic value. FRS-3 however requires depreciated replacement cost to be used as the surrogate for fair value. This means that ODV valuations will not be able to be used under FRS-3 if the economic value is lower than depreciated replacement cost.

Depreciation

FRS-3 considers depreciation to be a measure of consumption not a valuation method. It therefore envisages that all assets will need to be depreciated other than land and because they have limited useful lives (albeit some assets such as infrastructure and heritage assets such as artworks and museum collections may have very long lives).

Impairment

SSAP-28 only requires a write-down where a permanent diminution in value causes the recoverable amount to fall below the net carrying amount. Determining when an impairment is permanent can be a very subjective judgement.

FRS-3 requires an entity to review the carrying value of its assets each balance date to assess whether there is any indication that the item may be impaired. If there is an indication that the carrying amount exceeds the asset's 'recoverable amount' (the higher of net market value and the present value of the net future cash inflows expected from the asset's continued use and ultimate disposal), then the entity must estimate the item's recoverable amount. If there is a shortfall, then the carrying amount must be written down to the recoverable amount whether the impairment is temporary or permanent. FRS-3 also makes it clear that when estimating the asset's 'value-in-use' that the net cash inflows are discounted. SSAP-28 was silent on this.

Differential reporting

Entities which qualify for differential reporting may:

- adopt IRD depreciation rates
- choose not to capitalise borrowing costs
- choose not to make certain disclosures (those marked with an '*' in the standard)

Transitional provisions

Entities which had availed themselves of the transitional provisions under SSAP-28 (ie carrying items at a valuation established prior to 31 October 1991) may continue to adopt that transitional provision.

Entities carrying infrastructure assets which were not using methods of accounting that comply with FRS-3 requirements on subsequent expenditure, depreciation and/or impairment have two additional years to comply with these sections of FRS-3 (periods ending on or after 31 March 2004).

Where an entity is carrying revalued infrastructure assets but has not maintained a revaluation reserve for each component, FRS-3 exempts the entity from complying with the requirement to reduce the revaluation reserve on disposal of individual items until periods ending on or after 31 March 2007.

New disclosures

Disclosures required in addition to those currently required under SSAPs 3 and 28:

Carrying values

- Carrying amount of property, plant and equipment not in current use with separate disclosure of:
  - items that have been withdrawn from use
  - items under construction

Impairment

- Total of impairment losses recognised during the period
- Total of impairment losses reversed during the period

Revaluations

- Revaluation surplus by class of asset
- Details of any significant assumptions or limiting conditions upon which the valuations are based

Change in measurement base

- When an entity elects to stop revaluing a class of property, plant and equipment:
  - the fact that the class of items is no longer accounted for under the modified historical cost system of accounting; and
  - the basis upon which the class of item is now accounted for (ie on the basis of historical cost or on the basis of the most recent valuation but by applying the historical cost principle to the revalued amounts)

- When the measurement base for any class of property, plant and equipment is changed:
  - the change in accounting policy in accordance with FRS-1: Disclosure of Accounting Policies
  - whether the measurement base has been changed previously and, if so, when

Depreciation

Where the depreciation charges for any reporting period have changed because of:

- the reassessment of useful lives or residual values
- changes in depreciable amounts arising from revaluation
- changes in the depreciation method

then that fact and the financial effect must be disclosed.

You will need to select an appropriately qualified valuer for the class of asset you intend to revalue

Transitional provisions

Any adjustment arising as a result of applying the standard for the first time (except impairment losses) is treated as a prior period adjustment. The adjustment itself must be disclosed and its nature explained.

What are some of the things I need to do to comply with the new standard?

Consider whether complex assets should be broken down into smaller components

Do assets have significant component parts which have differing useful lives? If so, then the cost of the asset must be broken down into those parts and each component must be accounted for separately. When the component parts are replaced, the old components are treated as disposals and the replacement components are capitalised.

The level of components will be a matter of judgement for each entity depending on the nature of its assets. We suggest that you consider the replacement cost of the various components and how significant the impact on the statement of financial performance would be if you had to treat the expenditure as repairs and maintenance (or the carrying value of the old component as a loss on disposal) in the year the component needs replacing. As an example, replacement of tyres on a motor vehicle may not be a significant expense however replacing the lining of a furnace half way through its life may be.

Allocate cost or valuation to component parts

This may be done by reference to the original cost if the records are available and in sufficient detail to do this otherwise you will need to determine an appropriate methodology to allocate an asset's cost or valuation to components (eg by reference to replacement cost by component). You may need an appropriately qualified valuer to assist in this process.

Determine polices for the treatment of expenditure

The treatment of expenditure will depend on the determination of the level of components accounted for. Where an asset has been broken down into components, then the replacement of a component will be capitalised otherwise it will be expensed as repairs and maintenance. A comprehensive policy on the treatment of various types of expenditure should be developed to ensure a consistent approach.

If revaluing, determine an appropriate valuation methodology and project manage the valuation process to ensure the best result

You will need to select an appropriately qualified valuer for any class of asset you intend to revalue (ie with a relevant professional qualification and with experience in the location and category of property, plant and equipment being valued). If the valuer works for your organisation you will need an independent valuer to review the basis of the valuation. You will need to liaise with the valuer closely to ensure that the valuation is carried out in accordance with the standard, especially if the basis of valuation is depreciated replacement cost. It may also be worthwhile getting your auditors involved at an early stage to agree on the basis of valuation.

It will be important to ensure that component parts in particular are determined and accounted for at an appropriate level for the organisation. It may be expedient to make use of valuation handbooks for the class of asset you are valuing by taking these and making them entity-specific. If the basis is depreciated replacement cost you will need to ensure that there is adequate base data for the valuer to use to determine replacement cost. The more specialised the asset, the more input is likely to be required of management in liaising with the valuer to assist in determining component levels and appropriate optimisation.

For more information on the new standards, contact Denise Hodgkins, or your local Deloitte adviser.

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