Accounting for . . . tangible fixed assets

The term ‘Notes’ in this paper refers to the Notes to the Accounts

1 Foreword

1.1 The following advice applies to Methodist entities (districts, circuits and churches) whose annual financial reporting is accruals-based, whether by requirement or election. It applies to entities in England and Wales and Its principal impact will be on treasurers of churches. Its focus is land and buildings. The contents apply just the same if an entity is incorporated as a company.

1.2 We expect that many treasurers, especially those who have been using a validly adopted deemed cost since FRS102 came in, will need to make few, if any, changes.

2 Background

2.1 The Methodist Church has, for many years prior to SORP(FRS102), allowed, or even encouraged, its entities to value their fixed assets in the Balance Sheet - principally manses and church buildings - at their insured values. It had been our understanding that this was custom and practice and, therefore, acceptable even under the short-lived SORP(FRSSE), as well as for Receipts & Payments as the accounting basis. [In the latter case, the only requirement under charity law is an adequate description of each non-monetary asset and an indication of its fund-ownership, and the insured value is quicker and easier to cite than a cost figure.]

3 CC and FRC

3.1 We do not know of any case where the Charity Commission (CC) has challenged the use of insured values since FRS102 came into force, but, as church accounts tend to be well below the radar for regulatory scrutiny, that cannot be taken as a sign of CC concurrence with the insured value basis *post* FRS102. There may have been a few challenges by auditors and independent examiners.

3.2 Similarly, we are not aware of any indication from the Financial Reporting Council (FRC) that insured value is unacceptable (other than within FRS102 for its rules on using Depreciated Replacement Cost (DRC) for specialised assets if current value is adopted). But that, too, is no sign of FRC concurrence, for the same reason.

4 Categorisation of fixed assets

4.1 We might also observe that in many cases depreciation policies fail to split fixed asset figures into constituent parts with differing lives, *eg* land, buildings, organ, heating systems, sound and projection systems, and that neither dilapidations nor site clearance costs have been deducted from the insured value – not to mention the disregarded site value. This is detail that needs to be shown in the Notes to the Accounts explaining the valuation basis and the depreciation policy.

5 Valuers

5.1 The Church has not recommended the appointment of professional valuers, largely perhaps, to avoid the cost to the entities of engaging valuers. This continues to be the Church's recommendation.

5.2 It might, however, be necessary for the trustees to obtain an expert assessment of the property's market value at least every five years in order to satisfy FRS102 if the option to use "fair value" (instead of the preferred option of actual or deemed historical cost) is taken, depending on the materiality of the figures.

6 FRSSE and FRS102

6.1 The Methodist Church's website advice about this, which has not been updated since the demise of SORP(FRSSE), is not in line with SORP(FRS102). This now needs rectification. Its impact will be principally on church treasurers and occasionally on circuit treasurers where a circuit holds a redundant chapel or a lot of manses.

6.2 Those entities that, having adopted SORP(FRSSE) for 2015/16, established as its 'deemed cost' a property's existing carrying value in the balance sheet as at 1 September 2015 upon first adopting SORP(FRS102) for 2016/17, this being one of its transitional provisions, may continue to use that cost figure. In these circumstances treasurers should bear in mind:

- The Notes should make plain how the deemed cost was arrived at. If deemed cost, arrived at by ‘freezing’ the property’s valuation in the balance sheet prior to SORP(FRS102), has not already been used, it is now no longer possible to invoke it as a valuation option. If deemed cost was determined by reference to insured value, that may continue to be used as the cost under FRS102.

- If the market value is thought to be below the deemed cost, the difference represents an impairment that should be charged as an expense and shown as a deduction from the property’s carrying value in the Balance Sheet (B/S).

- Annually the trustees should carry out an impairment review of each tangible fixed asset whose disposable value might have fallen below its carrying value in the Balance Sheet.

- The financial policy on depreciation should be clearly explained in the Notes. Depreciation is provided to recognise the cost of a fixed asset’s depreciable value within the costs of each year’s operations. Only if that figure is immaterial both for the year and cumulatively can a policy of non-depreciation be justified. This will generally be in the following two cases: either the asset has an indefinite useful economic life or its carrying value is updated each year to fair value, and the Notes will then need to explain this.

- If the open market value is greater than the value shown in the accounts, no action is needed unless the asset is being carried at fair value.

7 Options

7.1 This paper offers a practical solution so that treasurers can adopt a method of valuation that is compliant with FRS102 and can be done for the year to 31 August 2019. Here is new advice on estimating-bases for church buildings and manses to be carried in the Balance Sheet at current value for lack of an actual or deemed historical cost or else as the property’s deemed historical cost if this is your first year of accruals accounts under SORP(FRS102). That will affect only a small proportion of the Church’s entities - those already or newly on accruals accounting – but still significant in absolute terms (possibly 250 treasurers nationwide) though many who already use deemed cost will find they may have a little to adjust.

7.2 Most church treasurers do not know the historical cost to date of the buildings that they occupy, buildings constructed 100, 200 or more years ago - including improvement costs since then. So those treasurers must use a best estimate of the property's fair value if accounting under SORP(FRS102), and *either* freeze it as the deemed historical cost under FRS102 on first moving from R&P-based accounts to accruals accounts *or* update it annually if they have missed that particular boat. There are two options for estimating fair value:

- open market valuation, *e.g.,* for a manse, or for a church building not too specialised to be readily marketable
- the discounted replacement cost (see below for an example).

7.3 The Statement of Assets and Liabilities (SoAL), used where the entity prepares Receipts and Payments accounts, can conveniently cite the insured value in lieu of a description for each substantial fixed asset, but that is only because no valuation is required. It cannot be transported to the Balance Sheet as the asset's carrying value on the accruals basis at the first need to prepare accounts compliant with SORP(FRS102). This is because FRS102 only allows a *pre-existing* Balance Sheet carrying value to be adopted as the asset's deemed historical cost to date, and the SoAL is not a Balance Sheet within the meaning of FRS102.

7.4 In reporting under SORP(FRS102), both the land and the buildings themselves have to be carried in the Balance Sheet at one of the following options:

1. estimated historical cost (actual, or deemed), *or*
2. current open market value, the proxy for which is discounted replacement cost (sometimes known as DRC).

7.5 The actual cost may involve treasurers looking through Land Registry records and/or title deeds (where the church still has them), using indices of building-costs to arrive at an estimated historical cost to date including all substantial improvements. That process is tedious, long-winded and produces a result which, whilst valid under FRS102, is quite unnecessary for a Statement of Assets and Liabilities (SoAL).

7.6 The only other option under FRS102 is fair value, meaning the current open market value, or DRC as a substitute, *eg*, for a specialised church building not readily convertible to alternative uses (subject to planning consents), whether or not the accounts are subject to audit, requires annual updating, which would probably be administratively costly. Furthermore, a depreciation policy is then required under FRS102 unless the current value option (annually updated) is taken in the absence of a reliable historical cost figure (actual or deemed).

7.7 Incidentally, the insured value is usually the cost of demolition and site clearance plus the rebuild cost "as new". Insurers might well be prepared to visit the church to assess its rebuild cost at today's prices, as well as indicating what the annual premium would be on the "fair wear and tear" basis, *i.e.* where the current state of repair is taken into account, which means discounting for any dilapidations.

8 Manses

8.1 Most of the foregoing applies to churches with no readily ascertainable market value. For manses, as well as for some church buildings, there is a ready market and for manses it is relatively easy to find the market values online or through viewing the windows of local estate agents.

8.2 Circuits may know the historical cost (the price paid) of some manses but not of others. It is not acceptable just to determine the open market value of those manses for which the cost is not known and to add these values to the historic costs where the price paid is known unless the FRS102 requirement for the same accounting policy to be applied to all assets of the same class can be interpreted accordingly, whereas it is normally the physical characteristics and/or what the assets are used for that determine their "class" for accounting purposes. In the related Note there should, if FRS102 is interpreted in such a way, at least be an indication of the number of manses at cost and the number at current value and the monetary total for each such class, as components of the total shown in the Balance Sheet.

9 Determining the need to adopt accruals accounting

9.1 A charity (other than a company) must adopt accruals-based accounting if its gross income is in excess of £250k in any financial year when calculated on a receipts and payments basis, as that basis then cannot be adopted under the Charities Act 2011.

9.2 For R&P accounts, endowments received in the period are excluded when calculating gross income, along with loans made to the church, and the sale proceeds from any investments and from fixed assets used by the charity for its own activities. However, any endowment capital spent as income must be included. This all accords with the Annual Return Regulations made by the Charity Commission each year.

9.3 In looking at the gross income threshold for accruals-based accounts, as well, any transfers from endowment capital to general reserves, or to restricted income funds, with a view to their being spent as income, must be included.

9.4 In all cases, funds and donations collected by an entity on behalf of another charity (*i.e.* as its agent) and which are then paid to that other charity, must be excluded in this calculation. This includes *inter alia* connexional assessments on circuits collected by districts and paid over to the Methodist Church Fund.

10 Are any of the restricted income reserves really unrecognised endowment capital?

10.1 If so, this could mean that the entity has wrongly disclosed income over £250k in its annual accounts and would not have to prepare accruals-based accounts at all if the exclusion of endowment receipts (*e.g.* donations intended to provide an asset for long-term use, *ie*, a fixed asset) which are being erroneously classified as restricted income would bring the gross income to below £250k. This could be a useful and opportune moment to correct the accounting error if, for example, a restricted fund had been created for a forthcoming building project and donors were making their donations in anticipation that the trustees would spend their donations on a long-lasting asset.

10.2 In these circumstances, the restricted fund constitutes an expendable endowment and must be retitled as endowment capital, not as a restricted income fund. This can and must be done as soon as the error comes to light. The accounting correction is valid retrospectively, albeit without needing to replace the statutory accounts of previous years - as long as the current year's accounts adequately explain the reason for the correction and how it affects the funds carried forward.

10.3 Even where in such a case the R&P basis is being retained, any references to the previous year's fund balances would certainly need restatement to show them on the correct basis. In the first year of adopting accruals accounting, the comparative figures to be restated from the R&P basis to the same accounting basis as the current year must be in line with the accounting policies and methodology used for this year's accruals accounts. A detailed Note explaining the correction to the funds classification and how it has affected the fund balances would be required.

11 Avoiding the risk of funds being donated for a restricted purpose for which they cannot be used ("failed trusts")

11.1 We have recently come across a few cases where a church has embarked on an ambitious building project and set a deadline for the raising of funds which it has failed to meet. The project has then been abandoned. Under these circumstances, it may be necessary to return the monies to the donors (or their next of kin, beneficiaries, those with power of attorney or executors). But the donors may not be known. So, we recommend that donors be invited to declare, when making their donations that, if the building project does not go ahead, their donations may be used generally for the work of the church. By the same token, it is good practice for this declaration also to cover any funds that turn out to be surplus to requirements once the project has been completed.

12 Elective accrual accounting

12.1 Some churches and circuits with income below the £250k threshold choose to present the more sophisticated accruals-based accounts, even though they could produce the much simpler R&P accounts. The statutory option of adopting R&P is still available and allows the treasurer then to avoid having to consider the cost or current value of the non-monetary fixed and current assets. The reason that the Church discourages switching back to R&P is that for two or three years after the change, unless a carefully maintained 'prompt payment' regime minimises fluctuations in receipts and payments year on year, the monetary numbers in the R&P Account and any in the SoAL can be misleading to readers looking to assess financial viability.

12.2 Accounts prepared on the accruals basis under FRS102 are much more useful to readers for comparison purposes generally, but they come at a cost to the treasurer in the time spent on preparing the accruals accounts and their detailed Notes.

13 Discounted Replacement Cost (DRC) explained

13.1 DRC is a formulaic solution to the problem of estimating a current market value for specialised buildings for which there is no active market and thus no readily available comparison data for the valuer to use. It is a cost consultant (quantity surveyor)'s estimate of "fair value" in terms of the cost at current prices of a complete replacement for the existing building, discounted to allow for the expired portion of the building's currently anticipated ***total*** "useful economic life", plus the cost of a suitable alternative site to the existing land. The discounting is to allow a reasonable sum for cumulative depreciation based on the existing building's current condition (dilapidations) and anticipated ***remaining*** useful economic life as a proportion of its total life.

13.2 *Example*
Current age of church building 60 years; in good condition (*i.e.* no dilapidations)
Anticipated future life 40 years
Cost unknown; also unknown how the cost figure in the B/S was derived
Estimate of cost of complete replacement £4m for the building as at the relevant year-end, and a further £100k for an alternative site of equal utility within the area of the church's current and envisaged local activities
Assumed useful economic life of replacement: 50 years

Discounting of replacement cost = (60/60+40) x £4m, *i.e.* £2.4m
"Fair value" of church property on DRC basis = £4m-£2.4m, *i.e.* £1.6m, plus land value £100k = £1.7m

13.3 Here, it is appropriate only for church buildings considered not readily convertible into non-specialised units with a readily available market price, such as for residential use subject to planning consents, *etc*.

13.4 Once calculated, the DRC valuation can be updated annually to satisfy FRS102 where the option for 'current value' accounting is taken for any class of fixed assets instead of the default (historical cost less cumulative depreciation). For the church community, as the <u>starting point</u> the insured rebuild figure on which the current year's premium is based, if estimated on a 'new for old' basis, is likely to be acceptable, as it will necessarily have been estimated on DRC principles. However, this must then be adjusted by reference to the existing church building's current condition and its anticipated remaining useful economic life, in order to equate to a professionally calculated DRC figure for use in the annual accounts under SORP(FRS102), not forgetting the non-depreciating land component. Many treasurers will be able to make these calculations themselves. Again, as with valuers, we are not suggesting that it is necessary to refer this matter to a cost consultant thereby incurring a professional fee.

14 Depreciation

14.1 Where the policy is to keep the structure and fabric in such good repair that the property continues to have an indeterminate useful economic life in the opinion of the trustees and their auditor/examiner, the generally accepted view for FRS102 compliance is that depreciation can be disregarded as immaterial.

14.2 In other cases, if the current disposal value of the property (*ie*, its “fair value” is thought to be less than its carrying value in the Balance Sheet FRS102 requires an “impairment” provision to be raised in that year's accounts. This cannot happen where that carrying value is based on DRC, which is itself a best approximation to current disposal value.

14.3 For strict compliance with the FRS102 rules on depreciation policy the building and the land it stands on must be taken separately. Annual increases in the market value of the land for its redevelopment potential cannot be used to justify non-depreciation of the building.

14.4 On the other hand, the FRC distinction here is a fine one for the charity sector, and so it seems unlikely that a regulatory challenge could arise as long as the trustees and their auditor/examiner can see eye to eye and can thus avoid a 'non-standard' accounts-scrutiny report and its compulsory whistle-blowing by the auditor/examiner to the CC.

15 Action plan

1. Determine or estimate which side you will be of the income threshold for accruals basis.

2. If you have an actual historical cost, use that.

3. If you have used insurance values, work through this paper.

4 If you have a gross income above £250k on the R&P basis, you must adopt the accruals basis.

5 Consider whether you have to reclassify a “restricted reserve” intended for provision and use of a ***long-lasting*** asset as an expendable endowment instead, meaning that it is really a ***trust capital*** fund. If in correcting this mis-classification this means you remain below the £250k, you may continue with R&P or elect to adopt the accruals basis.

6 Look at your Notes and ensure that you include the information suggested above (classes of fixed asset, bases of valuation *etc.*

7 Engage with your auditor/examiner so that they know what you are proposing and do not have to disagree with your proposal on technical grounds.

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