UITF abstract 23

Application of the transitional rules in FRS 15

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The issue

An issue has been raised on the application of paragraphs 106 and 108 of FRS 15 'Tangible Fixed Assets' and how widely the prior period adjustment approach may be used. The relevant basic requirement of FRS 15 is paragraph 83, which states: 1

"83 Where the tangible fixed asset comprises two or more major components with substantially different useful economic lives, each component should be accounted for separately for depreciation purposes and depreciated over its individual useful economic life."

Paragraphs 36 - 41 also discuss the treatment of expenditure on components.

The transitional rules in paragraphs 106 and 108 are as follows: 2

"106 Except as provided for in paragraph 108, revisions to the useful economic lives and residual values of tangible fixed assets recognised on adoption of the FRS are not the result of a change in accounting policy and should be treated in accordance with paragraphs 93-96 [ie prospectively] and not as prior period adjustments."

"108 Where, on adoption of the FRS, entities separate tangible fixed assets into different components with significantly different useful economic lives for depreciation purposes, in accordance with paragraphs 36-41 and 83-85, the changes should be dealt with as prior period adjustments, as a change in accounting policy."

Prior to the adoption of FRS 15 an entity may have based its depreciation policy on the whole of an asset, such as property, while recognising that certain components, such as lifts, had a substantially shorter life than the property as a whole: the cost of replacement of such components would have been provided for by means of a provision (prior to FRS 12) or written off as incurred. On adoption of FRS 15 an entity may at the same time (a) identify one or more separate components with significantly different useful economic lives from the remainder of the asset and (b) amend the residual value and/or economic useful life of the remainder of the asset. A typical example would be where the lifts within a building are to be treated as a separate component and depreciated separately and at the same time the building itself is to be depreciated for the first time. The question is whether the effect of both aspects can be combined into a single prior period adjustment under paragraph 108. 3

4 Since paragraph 106 is expressed as being subject to paragraph 108, it could be read as placing no limits on the extent to which prior period adjustments could be set up in respect of changes to depreciation rates on the introduction of component accounting. The UITF took the view that paragraph 108 should not be taken as disapplying paragraph 106 with regard to all elements of an asset in which one or more components had been identified on the adoption of FRS 15, but rather as introducing a limited exemption to deal with the situation discussed in paragraph 3 above. The UITF noted that paragraph 106 itself reflects the ongoing requirements for revisions of residual values and/or economic lives (set out in paragraphs 93-96) which is that they should be reflected prospectively over the remaining useful life of the asset. Allocating a shorter life to components of an asset does not itself involve changing the life/residual value placed previously on the asset as a whole. However, reviewing the asset as a whole may also give rise to changes in the estimates of its life/residual value: such changes should be dealt with prospectively.

5 FRS 15 notes that land and buildings are separable components and are dealt with separately for accounting purposes, even when they are acquired together (paragraph 84). Where they had not previously been treated separately and there had been no charge for depreciation, any depreciation of the buildings component arising from the introduction of FRS 15 should be dealt with prospectively.

6 Before the adoption of FRS 12 'Provisions, Contingent Liabilities and Contingent Assets' and FRS 15, the fact that some components deteriorated faster than the asset as a whole might have been recognised by a provision for repairs and maintenance (including major refits or refurbishment and the replacement of major components) rather than by different depreciation rates on the components. On adoption of FRS 12 any such provision would have been eliminated by a prior period adjustment. It follows that it was necessary in FRS 15 to allow prior period treatment in respect of the corresponding adjustment resulting from recomputing cumulative depreciation by reference to components of an asset rather than the asset as a whole.

Application to smaller entities

7 Reporting entities applying the Financial Reporting Standard for Smaller Entities currently applicable are exempt from this Abstract.

UITF consensus

8 The UITF reached a consensus that the prior period adjustment required by paragraph 108 of FRS 15, where components of an asset are identified, should be restricted to the effects of treating separately only those components in respect of which:

(a) any provision for repairs and maintenance (including replacement expenditure) was itself eliminated by prior period adjustment on adoption of FRS 12 or

(b) there has been a change from a previous policy of writing off as incurred relevant repairs and maintenance expenditure (including replacement expenditure) to a policy whereby such expenditure is capitalised because it replaces a separately depreciated component.

In particular, any prior period adjustment should not embrace any changes to the useful economic lives or residual values of the remainder of the asset.

Date from which effective

The accounting treatment required by this consensus should be adopted as soon as practicable, but in any event in financial statements relating to accounting periods ending on or after 23 March 2000 (the effective date of FRS 15). 9

References

FRS 15 'Tangible Fixed Assets' - paragraphs 36-41, 83-4, 93-96, 106 and 108.
FRS 12 'Provisions, Contingent Liabilities and Contingent Assets' - paragraphs 14, 101 and Example 11 in Appendix III.

Appendix

Illustrative Example

Assume a building with a cost of £1 million, on which before FRS 15 no depreciation had been charged on the ground that any depreciation was immaterial. Inflation is ignored.

Ten years after the purchase of the building FRS 15 is adopted and the lifts within the building are identified as a separate component with a cost of £150,000 and a 20-year life. Assume (as an example of a paragraph 8 (a) situation) that a provision for the replacement of the lifts had been built up, amounting to £75,000 (10/20 x £150,000). However, on the adoption of FRS 12 the provision is eliminated as a prior period adjustment.

Clearly the lifts have been in existence since the date of purchase and have always had a cost and a life (and possibly a residual value, assumed to be nil in this case).

On adoption of FRS 15 the lifts are formally recognised as a separate component in accordance with the standard and cumulative depreciation of £75,000 (being the difference between the amount of depreciation previously charged, ie nil in this case, and the recalculated amount) is charged in respect of that component by way of prior period adjustment in accordance with paragraph 108. In this case, this is equal and opposite to the prior period adjustment required on the adoption of FRS 12 (for simplicity it has been assumed that FRS 12 and FRS 15 were adopted at the same time, which may not have been the case in practice). This adjustment, of itself, should not result in revision of any depreciation previously charged in respect of the building excluding the lifts (nil in this example).

If (as an example of a paragraph 8 (b) situation) no provision had been made for replacement of the lifts, but the policy had been to write off as incurred the replacement of major components such as lifts, then the prior period adjustment on the adoption of FRS 15 would be £75,000 cumulative depreciation as above. When the lift is eventually replaced the new lift will be capitalised as it replaces a separately depreciated component.

In both examples above, any change to the life (or residual value) of the building as a whole should be accounted for prospectively under paragraph 106. Thus if the building was given a revised useful economic life of 50 years (ie a remaining useful economic life of 40 years) on adoption of FRS 15, the depreciation on the building (excluding the separately depreciated lift) would be accounted for prospectively, ie £21,250 per year (1/40 x £850,000).