

Financial Reporting Update

March/April 2008

KPMG LLP (UK)

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FRS 20: Vesting Conditions and Cancellations

The Accounting Standard Board (ASB) has issued an amendment to FRS 20 *Share-based Payment on Vesting Conditions and Cancellations*, following a similar amendment to IFRS 2 issued in January 2008 by the IASB. This amendment clarifies the definition of vesting conditions and introduces the concept of non-vesting conditions. It also amends the accounting for cancellations and settlements by parties other than the entity.

The amendment changes the definition of vesting conditions and restricts vesting conditions to newly defined service and performance conditions. What this means is that it is clear that reversal of the share-based payment charge is not possible when the employee fails to meet a condition that the standard defines as a “non-vesting condition”. Instead, the probability of not meeting these conditions is reflected in an adjusted fair value (lower) at grant date. Examples of non-vesting conditions are the requirement by an employee to save in an SAYE scheme, for an employee to hold a share to be entitled to a free share (matching share) or a share-based payment that is linked to commodity prices.

Additional implementation guidance is provided to help identify vesting and non-vesting conditions.

The amendment also changes the scope regarding cancellations and settlements to include cancellations and settlements by parties other than the entity. This presents a significant change to the previous position where only cancellations by the entity were covered. The most commonly expected scenarios covered by this will be the cancellations of SAYE schemes by the employee or the sale of shares held by the employees to qualify for matching shares as described above. A cancellation or settlement is required to be accounted for as an acceleration of vesting and therefore will result in an acceleration of the charge recognised in the financial statements of the entity.

A copy of the press notice is available at:

<http://www.frc.org.uk/asb/press/pub1553.html>



The amendment requires full retrospective application. Companies with existing arrangements containing non-vesting conditions such as SAYE schemes, 'matching share' and commodity linked arrangements will require an updated valuation.

These amendments are effective for annual periods beginning on or after 1 January 2009, with earlier application permitted.

Abolition of IBAs: Deferred tax implications

The 2007 Budget proposed changes in relation to the tax allowances applicable to certain capital assets. In particular, and as confirmed in the 2008 Budget on 12 March 2008, it was announced that Industrial Building Allowances (IBAs) will be phased out by 2011. This article summarises the deferred tax consequences of this change under both UK GAAP and IFRS; the appendix to this issue of *Update* discusses the matter in more detail.

Timing of recognition and disclosure

Any deferred tax effect of the IBA abolition will not be recognised until substantive enactment of the Finance Act 2008, which we anticipate – based on the date of substantive enactment of the Finance Act 2007 – will occur in late June 2008. In advance of this, the anticipated effect of the announced changes should be disclosed in accordance with FRS 19 *Deferred Tax* or IAS 12 *Income Taxes*, which both effectively require disclosure of significant factors that could affect the future relationship between tax expense and accounting profit. Where the announcement of the change took place after the balance sheet date but prior to the approval of the financial statements, IAS 12¹ specifically requires disclosure to be made of any significant effect of a change in tax laws.

Effect on deferred tax balances

UK GAAP

The effect of the removal of IBAs on deferred tax balances under UK GAAP is straight-forward. Any deferred tax previously recognised on differences between the receipt of IBAs and the depreciation on the related buildings will already have been derecognised in accordance with FRS 19 upon substantive enactment of the Finance Act 2007 which removed the balancing adjustments on disposal of an asset. Consequently the phased removal of IBAs will have no effect on deferred tax balances under UK GAAP.

IFRS

The position under IFRS is less clear; more than one view exists on how this should be treated under IAS 12.

¹ See also IAS 10 and FRS 21 *Events after the balance sheet date*.

In KPMG in the UK's preferred view, in the majority of cases the tax base of the building is unchanged (future tax deductions now being represented by a capital gains tax deduction rather than IBAs). Consequently, any related deferred tax liability will also be unchanged. However, in the case of a deferred tax asset, its recoverability will need to be reassessed as this now represents a capital loss.

An alternative view considers the consequences of using and selling the building separately. Under this view it is likely that the abolition of IBAs will result in a substantially increased deferred tax liability under IAS 12.

Companies reporting under IFRS will have already, in most cases, made an accounting policy choice about how to measure deferred tax in respect of dual-use assets and this choice will determine how the proposed abolition of IBAs will affect their deferred tax balances.



Takeover Directive disclosures – a reminder

The Financial Reporting Review Panel (FRRP) has recently published its findings following a review of the disclosures given in the directors' report by companies in relation to the Takeover Directive. The FRRP found that a small number of publicly traded companies had not provided the required disclosures.

A copy of the press notice is available at:

<http://www.frc.org.uk/frp/press/pub1522.html>.

The March/April 2007 Update is available at

www.kpmg.co.uk (in Publications under the 'Audit' category).

As discussed in the March/April 2007 *Financial Reporting Update*, the disclosures required by the Directive have been implemented into UK law at paragraph 13 of Schedule 7 to the 1985 Act. They are concerned with a company's capital structure and various related matters, regardless of whether the company has been or is involved in a takeover.

The disclosures are required of companies whose voting securities have been admitted to trading on a regulated market at the end of the financial year and are applicable for financial years beginning on or after 20 May 2006.



Financial assistance by private companies

The Fifth Commencement Order for the Companies Act 2006 (see December 2007 – February 2008 *Update*) removes the prohibition on a private company giving financial assistance for the acquisition of shares in itself or in a private holding company. The prohibition will be lifted for financial assistance given on or after 1 October 2008.

To implement this, the Fifth Commencement Order repeals (for private companies only) sections 151 to 153 and 155 to 158 of the 1985 Act with effect from 1 October 2008. This repeal means that private companies will no longer have to go through the “whitewash” procedure. The prohibition on giving financial assistance will remain in place for public companies.

As part of the repeal, a savings provision is introduced to resolve a problem that has arisen since the Act was passed. The problem was a concern that the effect of the common law might also prohibit financial assistance, thus rendering the statutory repeal to be of no practical benefit. To address this issue, the savings provision clarifies that after this repeal a transaction that is currently prohibited by section 151 (but would otherwise be lawful) will not be prohibited by any rule of law (i.e., the common law) relating to the giving of financial assistance by a private company for the purpose of the acquisition of shares in itself or another private company.

However, there may be cases where a transaction was prohibited by section 151 and is also unlawful for some other reason; it would remain unlawful for that other reason. For example, if a company without distributable profits made a gift (or undervalue sales) to an acquirer of shares, this transaction would still be unlawful as it represents an unlawful distribution / return of capital.



Enforcement decisions

Eleven enforcement decisions by national accounting regulators have been published by the Committee of European Securities Regulators (CESR), with the objective of contributing to consistent application of IFRS within the EU.

Within CESR, the European Enforcers Coordination Sessions (EECS) are a forum in which enforcement decisions taken by EU national enforcers are discussed and analysed. EECS is not a decision-making forum; it neither approves nor rejects decisions taken by individual national enforcers. However, EECS does review the contents of its database of decisions regularly and decides which decisions ought to be published on an anonymous basis. The purpose of publication is to inform companies in the EU of treatments that are considered by the national enforcers to be within the acceptable range of those permitted by IFRS standards or interpretations but it should be noted that the published decisions are not themselves interpretations.

Decisions published in this extract which, although based on specific facts and circumstances of a particular case, may be of general interest include:

- operating divisions discussed in the “front end” of the annual report should not be aggregated into a single operating segment for IAS 14 purposes;
- use of the fair value option is permitted even when some of the assets or liabilities in the accounting mismatch are not financial instruments;
- an average pay pension scheme where the entity pays insurance premiums to a third party insurance company and risks, however small, remain with the entity is a defined benefit scheme not a defined contribution scheme;
- excise tax paid when goods leave bonded warehouses should be treated as part of cost of sales and not netted off revenue;
- property developers’ contracts to construct commercial property, housing for a cooperative and apartments should be accounted for as the sale of goods and not as construction contracts. IFRIC Draft Interpretation D21 is proposing to issue further guidance on whether the sale of real estate falls within the scope of IAS 18 or IAS 11.

The CESR’s press release can be found at:

<http://www.cesr-eu.org/>

[index.php?page=contenu_md&type=press§ion=Press%20Releases](http://www.cesr-eu.org/index.php?page=contenu_md&type=press§ion=Press%20Releases)



Consolidated guidance on distributable profits issued

The ICAEW and ICAS have issued *TECH 1/08 Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 1985* which consolidates all previous guidance on the determination of realised and distributable profits issued by the Institutes.

TECH 1/08 consolidates:

- TECH 7/03 Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 1985 (as revised by TECH 2/07).
- TECH 50/04 Guidance on the effect of FRS 17 *Retirement benefits* and IAS 19 *Employee benefits* on realised profits and losses.
- TECH 64/04 Guidance on the effect on realised and distributable profits of accounting for employee share schemes in accordance with UITF Abstract 38 and revised UITF Abstract 17.
- TECH 2/07 Distributable profits: Implications of recent accounting changes (i.e., transition to IFRSs and converged UK standards).

It does not change the substance of the guidance previously issued in the technical releases above. It is a consolidation exercise only.

TECH 1/08 is available from the ICAEW at:

<http://www.icaew.com/index.cfm?route=154655>

As with TECH 2/07, the TECH reflects accounting standards in issue at 1 August 2007 and does not take into account the provisions of Part 23 of the Companies Act 2006 which is effective for distributions made on or after 6 April 2008.



IFRS 7 *Financial instruments: Disclosures*: Lessons learnt from round one

IFRS 7 *Financial Instruments: Disclosures* became mandatory for the first time for years ending 31 December 2007. Save for a few early adopters, early 2008 has witnessed the first wave of published IFRS 7 disclosure. In this article we will consider some of the differences from previous requirements that have had to be addressed in the move to IFRS 7 and KPMG in the UK's observations on the new requirements.

The key message is that IFRS 7 requires a company to disclose its own approach to the risks arising from financial instruments and how those risks translate into the numbers reported in the accounts. This "tell it your way" approach is supplemented by certain extensive mandatory disclosure requirements; since the devil of these has been very much in the detail, it is important to be aware of them.

IFRS 7 and FRS 29 applicability to parent companies

Where a parent company has adopted IFRS in its individual accounts, IFRS 7 – like IAS 32 that preceded it – does not provide for any exemption from disclosure. As a result, tailored disclosures should be given that reflect the parent's specific circumstances, including considerations of any inter-company receivables and payables. When a parent elects to account for investments in subsidiaries, associates, and joint ventures under IAS 39, IFRS 7 disclosures are also required with respect to those investments.

The individual accounts of many parents that are listed on an EU-regulated market are prepared under UK GAAP. Such entities are required to adopt FRS 26 and, as a result, FRS 29 (the UK equivalent of IFRS 7, which is mandatory for such companies for years ending on/after 31 December 2007). Unlike IFRS 7, FRS 29 does provide an exemption from disclosures in the parent's separate accounts, provided that the parent is included in publicly available consolidated accounts that contain disclosures that comply with the standard (e.g., IFRS 7).

Scope matters

A question arises as to whether prepayments or deferred revenue should be included within the IFRS 7 disclosures. This question arises from the way that such items are presented in the balance sheet – i.e., within trade and other receivables and payables. However, prepayments and deferred revenue are not financial instruments as defined in IAS 32 (as the Application Guidance in IAS 32 confirms) and should, therefore, be excluded from any IFRS 7 disclosures.

Conversely, it should be noted that all the requirements of IFRS 7 apply to all financial instruments within its scope. For example, credit risk disclosures are not restricted to trade receivables but also apply to all other financial assets – e.g., other receivables, cash and cash equivalents, and, in the case of parent companies, inter-company receivables. Another example is that IFRS 7 disclosures must be given for lease receivables and payables accounted for under IAS 17.

Analysis of financial assets and liabilities by IAS 39 categories

A new requirement of IFRS 7 is for an overall analysis of balance sheet carrying amounts of financial assets and liabilities by IAS 39 categories (e.g., available for sale, loans and receivables, etc) and gains and losses thereon. Of course, it may be that other disclosures in the accounts enable the reader to derive the information. However, those disclosures may not be sufficient to meet the specific disclosure requirements of the standard.

Qualitative disclosures about financial risk exposure and management

IFRS 7 calls for more extensive qualitative risk disclosure than IAS 32. In particular, IFRS 7 requires disclosure of internal processes for managing, and the methods used to measure, risk. Entities should not overlook these requirements notwithstanding the natural tendency to focus efforts on the quantitative disclosures. As with all qualitative information, “boiler plate” disclosures should be avoided. For example, given current market conditions, the IFRS 7 disclosures should generally address the specific effects of the “credit crunch” except where clearly irrelevant.

Credit quality of financial assets neither past due nor impaired

IFRS 7 requires information regarding the credit quality of financial assets that are neither past due nor impaired to be disclosed, such qualitative information should be given, which might include an analysis of credit exposure using an external or internal credit grading system, the nature of counterparties, historical information of default rates, and any other information the entity uses to assess credit quality. Such disclosures are by their nature entity-specific. Generally speaking, a trading entity will have controls and processes in place to protect itself from bad debts and control the credit quality of its trade receivables, and those controls and processes will serve as a starting point for obtaining the relevant information for the purposes of IFRS 7.

Reconciliation of allowance for credit losses

A reconciliation of the account for credit loss allowance should be given. This will apply when a separate bad debt provision account is used in the entity’s accounting records. Thus, entities that have made provision for bad debts as a separate item within the general ledger, for example, rather than reducing the carrying value of the financial asset directly, fall within this disclosure requirement.

Liquidity risk and withdrawal of IAS 32 contractual re-pricing table

Some confusion might arise on the relationship between the maturity analysis under IFRS 7 and the contractual re-pricing tables under IAS 32 – i.e., whether the amounts disclosed in the IFRS 7 maturity table should be based on balance sheet amounts as was the case for the IAS 32 repricing table. Maturity analysis under IFRS 7 should be based on contractual cash flows, which are not generally the same as balance sheet amounts. For example, for interest-bearing liabilities interest payments should be included in the maturity tables as well as principal repayments. For non-interest-bearing liabilities, the carrying amount in the balance sheet will be on a discounted basis. Another implication is that derivative liabilities should be included based on contractual cash flows, not balance sheet amounts, and within the time band in which these cash flows fall due.

Market risk – sensitivity analysis

For many entities, sensitivity analysis is the most onerous IFRS 7 disclosure requirement. This is because it involves the collection and analysis of a large amount of financial data and its preparation can therefore take some time. Some practical issues relating to sensitivity analysis are:

- how the effect of the sensitivity analysis should be estimated. The effect on profit or loss or equity for the following year needs to be determined at the balance sheet date assuming that a reasonably possible change in the relevant risk variable had occurred at the balance sheet date and had been applied to the risk exposures in existence at that date.
- the magnitude of the change in the market risk variable subject to sensitivity analysis. IFRS 7 specifically requires that the analysis should be based on the “reasonably possible” changes rather than a worst case scenario.
- the methods and assumptions applied for the purpose of this analysis must be disclosed.

IAS 1 Capital disclosures

As part of the IFRS 7 project, amendments were made to IAS 1, requiring new disclosures in respect of capital management. Whilst these requirements have received less publicity than IFRS 7, they should not be overlooked.


Conclusion

IFRS 7 represents a step change in the approach to disclosing risks arising from financial instruments. Some of the new requirements are obvious; some become apparent only through careful analysis of the requirements.

Ceasing to hold office as auditor

From 6 April 2008, certain complex and fundamentally new provisions of the Companies Act 2006 (ss516-526) will apply whenever a company changes auditor (or ceases to have an auditor at all). Most of this complexity falls upon the auditor, but there are some steps for companies to go through.

Broadly speaking, for the company the changes compared with the Companies Act 1985 regime are as follows:

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- a quoted company (i.e., a company required to prepare a directors' remuneration report) must always circulate, to its members and others entitled to a copy of the accounts, a copy of the auditor's statement on ceasing to hold office. For quoted companies, the auditor's statement will always lay out the circumstances connected with his ceasing to hold office (previously it gave only circumstances he wished to bring to the attention of members or creditors – this basis continues in relation to unquoted companies). This circulation by the company is subject to the usual procedure for the company to apply for a court direction otherwise.
 - in the case of early termination of office (e.g., resignation by the auditor – which is the usual case, e.g. where the outgoing auditor agrees to resign to facilitate replacement by the new auditor), the company must also inform the appropriate audit regulator (depending on the case either the Professional Oversight Board or the outgoing auditor's Recognised Supervisory Body, usually the ICAEW) and must provide it either with its own statement of the reasons for change or a copy of the auditor's statement (if it is of circumstances). The company cannot apply to court to stop this notification process.

Companies should also be aware that the auditor is required also to file his statement at Companies House (all cases) and to make a notification to the same audit regulator (early terminations and all cases in relation to Official List / major public interest companies). The audit regulator is required to notify the Financial Reporting Review Panel and the Secretary of State (all cases notified to the audit regulator) with copies of the various statements received if the audit regulator thinks fit.



IFRS newsletters

KPMG IFRG Limited has published the following since the December 2007 to February 2008 *Update*, which are available on our Web site at www.kpmg.co.uk:

IFRS publications

IFRS in Brief:

- February 2008 – A summary of the January 2008 meeting of the IASB
- March 2008 – A summary of the February 2008 meeting of the IASB

IFRS Briefing Sheets:

- Issue 86 – Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements *Puttable Financial Instruments and Obligations Arising on Liquidation*
- Issue 87 – U.S. Securities and Exchange Commission proposes amendments to foreign private issuer reporting requirements
- Issue 88 – IASB Discussion Paper *Financial Instruments with Characteristics of Equity*
- Issue 89 – IASB Discussion Paper *Reducing Complexity in Reporting Financial Instruments*
- Issue 90 – IASB Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits*



Appendix

The effect of the abolition of IBAs on deferred tax balances: a detailed review

The article Abolition of IBAs: Deferred tax implications earlier in this *Update* gives an overview of the changes and of the accounting implications. This appendix examines the accounting in more detail.

Summary of announced changes

The 2008 Budget Report stated that IBAs will be removed in stages between 2008 and 2011. The allowance will be reduced to 3 percent for the financial year 2008/9, 2 percent for 2009/10, 1 percent for 2010/11 and nil from April 2011.

If the building is disposed of in the future for less than its tax written down value (TWDV), its capital gains tax (CGT) base cost – i.e., the amount deductible in working out the capital gains – is restricted to its original cost less any IBAs claimed to date (i.e., the TWDV effectively becomes the CGT base cost)². For example, if an asset with an original cost of 1,000 in respect of which IBAs of 200 have been claimed to date (i.e., TWDV of 800) is disposed of for proceeds of 750, the capital loss arising is calculated as follows:

Proceeds		750
Less: original cost	(1,000)	
Add: IBAs claimed to date	200	
		(800)
Capital loss		(50)

Hence the effect of the proposed abolition of IBAs together with the disposal rules is to substitute a potential capital loss of an amount up to the TWDV; or in other words a minimum CGT base cost equal to the TWDV.

Effect on deferred tax balances

UK GAAP

The Finance Act 2007 abolished the balancing adjustment on disposal of an asset eligible for IBAs and thus the receipt of IBAs is now unconditional (as they are never repayable). FRS 19.11 states that deferred tax should be reversed once all conditions for retaining the allowances received have been met. Thus under UK GAAP any deferred tax previously recognised on differences between the receipt of IBAs and the depreciation on the related buildings will have been derecognised upon substantive enactment of the Finance Act 2007.

² If the building is disposed of for more than its original cost the CGT base cost is equal to its original cost (i.e., unrestricted by IBAs claimed to date). If the proceeds are above the TWDV but less than original cost, there is no gain or loss for CGT purposes

Any subsequent difference between any IBAs received and depreciation charged is a permanent difference. Consequently the phased removal of IBAs will have no effect on deferred tax balances under UK GAAP.

IFRS

Under IAS 12, deferred tax is recognised on the difference between the carrying amount of an asset and its tax base. It is therefore first necessary to establish the tax base of the building before considering any effect of the reduction in future IBAs and the related change in the CGT base cost.

IAS 12.7 states: "The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset."

IAS 12.51 states: "The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities."

IAS 12.52 goes on to state: "In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:

- the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
- the tax base of the asset (liability).

In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement."

There are three different ways in which the carrying amount of an industrial building may be recovered: through use, through sale or through a combination of use followed by sale (a dual-use asset). For assets that are expected to be recovered solely through sale, the proposed abolition of IBAs does not affect the tax base of the asset because the tax base in such cases is determined by reference to the CGT base cost, which is unaffected by the abolition of IBAs.

For industrial buildings that are expected to be recovered solely through use, the availability of capital losses for the lower of TWDV and original cost of the asset should, in our view, not be ignored. In the view of KPMG in the UK, as explained in the example discussed below, most assets which are on the face of it held for use should be treated for deferred tax purposes as dual-use and the calculation of deferred tax should follow the principles illustrated below.

For dual-use assets (and hence those held for use) the deferred tax arising may, depending on the entity's accounting policy choice, be calculated and presented either as a single balance or as an asset and a liability. There are consequently

two different views as to how the proposed abolition of IBAs affects the tax base of the related building where the building is to be recovered through use or is a dual-use asset: these views are illustrated in the following example.

Example

This example sets out the principles to be applied in a straight-forward illustration of a simplified scenario. However, each case should be considered separately and in applying these principles judgement must be used based on the particular circumstances of that case.

A freehold building was acquired on 1 January 2007 at a cost of 200. At the date of acquisition, the asset was eligible for IBAs at a rate of 4 percent per annum on a straight line basis.

Assume that the building is being depreciated over a 40 year period to a zero residual value. Management have no current intention to dispose of the building.

For simplicity, assume that the abolition of IBAs is to take effect in one step at 1 July 2008 (rather than the phased approach in fact proposed³). Assume that this is set out in the Finance Act 2008 which is substantively enacted on 1 July 2008.

What is the impact on the tax base of the building (ignore any effects of indexation for capital gains purposes)?

View 1

View 1 takes the approach that there is a single tax base attributable to the building.

The tax base of the asset on acquisition was 200 (being the amount that will be deductible for tax purposes based on tax laws that were substantively enacted at that date); hence no temporary difference existed at that date:

	NBV	Tax base	Difference
To be recovered through use	200	200	nil
To be recovered through sale	nil	nil	nil

At 30 June 2008 the net book value (NBV) of the building is 192.5 and the tax written down value (TWDV) is 188. Hence a taxable temporary difference of 4.5 exists, in respect of which a deferred tax liability has been recognised:

	NBV	Tax base	Difference
To be recovered through use	192.5	188	(4.5)
To be recovered through sale	nil	nil	nil

³ Under the phased approach to the removal of IBAs, a tax base of 6 percent of original cost (representing the remaining IBA entitlement) will remain. For simplicity this has been ignored in this illustrative example.

With effect from 1 July 2008, the building is no longer eligible for IBAs, although its TWDV will be deductible in the event of disposal. Although management have no stated intention to dispose of the building, a capital gains tax deduction will ultimately become available when the building, together with its related land, is ultimately disposed of and hence in the view of KPMG in the UK, the building should be treated as a dual-use asset.

In considering the expected manner of recovery of the building, SIC Interpretation 21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets* explains that the recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value. In this case, although the residual value of the building is assumed to be nil, a tax deduction will nevertheless be available upon ultimate disposal and this therefore forms the basis for determining the tax base. Further, for tax purposes, freehold land and buildings are considered to be one asset. The tax base of the land element will always be based on sale in accordance with SIC 21.6, which states “...the carrying amount of a non-depreciable asset, such as land having an unlimited life, will be recovered only through sale”. Upon such a sale a deduction will be available for both the land and building elements.

Consequently the tax base of the building is unchanged at 1 July 2008 – the amount that will be deductible for tax purposes remains the same, although it will now be available for deduction at a later date⁴. A deferred tax liability continues to be recognised on the taxable temporary difference of 4.5:

	NBV	Tax base	Difference
To be recovered through use	192.5	nil	(192.5)
To be recovered through sale	nil	188	188
Total	192.5	188	(4.5)*

*single deferred tax liability recognised on this amount

Subsequently, as the building is depreciated and its tax base remains unchanged, a deferred tax asset will eventually arise. This should be assessed for recoverability in the usual way – as this now represents a future capital loss (which is recoverable only by offsetting against capital gains incurred at the same time or later than the capital loss) consideration needs to be given to whether the deferred tax asset should be recognised.

View 2

View 2 also treats the asset as a dual-use asset from the date of acquisition, but reflects a policy choice that the deferred tax consequences of the use and sale of the dual-use asset should not be offset. It attributes two separate tax bases to the building as follows:

⁴ In the UK, the corporate tax rate applicable to capital gains is currently the same as that applicable to trading profits, therefore this article does not consider the effect of differing tax rates.

On initial recognition at 1 January 2007:

	NBV	Tax base	Difference
To be recovered through use	200	200	nil
To be recovered through sale	nil	nil	nil

No temporary differences arise on initial recognition.

Immediately before abolition of IBAs at 30 June 2008:

	NBV	Tax base	Difference
To be recovered through use	192.5	188	(4.5)
To be recovered through sale	nil	nil	nil

A taxable temporary difference of 4.5 has arisen and a corresponding deferred tax liability is recognised.

Immediately after abolition of IBAs on 1 July 2008:

	NBV	Tax base	Difference
To be recovered through use	192.5	nil	(192.5)*
To be recovered through sale	nil	188	188*

*separate deferred tax liability and asset arise on these amounts

The future tax deductions available through use have reduced to nil and consequently a substantially increased taxable temporary difference of 192.5 arises, equal to the NBV of the building, and a corresponding deferred tax liability is recognised. There is no exemption from the recognition of this liability, which will reverse over the building's remaining useful life as it is depreciated to nil.

At the same time a separate deductible temporary difference of 188 arises in respect of the "sale" element of the building; the recoverability of the corresponding deferred tax asset would need to be considered carefully because, as noted under view 1, it represents a future capital loss that may not be recoverable. If this asset is not recognised, the overall deferred tax position under view 2 would be a liability of 192.5.

In assessing whether such an asset should be recognised, a variation on view 2 takes the approach that, since management have no current intention to dispose of the building, this potential deferred tax asset should not be recognised at all. Whilst we acknowledge that the standard is unclear in this area, in the view of KPMG in the UK this argument is difficult to reconcile with the implications of SIC 21 that the building (with a nil book value in this case) will ultimately be disposed of together with its associated land.



Conclusion

KPMG's *Insights into IFRS* discusses the available accounting policy choice when the entity has dual-use assets. It states that our preferred approach is to treat the asset as having a single tax base (i.e., view 1 above) but that in our view it is also acceptable to consider the use and sale consequences separately (view 2 above).

An entity is likely already to have made this accounting policy decision – for example, in its recognition and measurement of deferred tax in relation to freehold land and buildings acquired in a past business combination where the fair value of those assets differed from their tax base (whether or not those assets attract IBAs). In the view of KPMG in the UK, the policy adopted in respect of the proposed abolition of IBAs should be applied consistently with any existing policy.

If you would like further information on any of the matters discussed in this *Update*, please talk to your usual contact at KPMG LLP (UK) or call any of our offices. Earlier *Updates* are available on our Web site, at www.kpmg.co.uk.

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