Tier 3 Public Benefit Entities

Simple Format Reporting

Should we Depreciate Buildings?

This document does not deal with historic buildings. Historic buildings have their own special requirements and definitions.

This document also assumes you are using the cost method of accounting for land and buildings rather than the revaluation method but the discussion is similar but the accounting policies and fixed asset (property, plant and equipment notes are different). On this basis there is no revaluation reserve.

What is Depreciation?

In terms of the glossary found in the Tier 3 Reporting Standard[1], depreciation is *"The allocation of the cost of the asset over its useful life using a structured method such as straight line or diminishing value"*.

Please note that the definition takes no account of residual value so in effect the Tier 3 standard allocates the whole cost of the asset over its useful life without consideration of its residual value. From a practical point of view we know that in most cases there is a residual value associated with a building and the residual value is higher than the carrying value.

What is a Structured Method of Allocating of the Cost of an Asset?

Within the Methodist Church we use the structured method called "straight line" rather than "diminishing value", so I will focus upon that method for the purpose of this report.

The term "straight line" is not defined within the Tier 3 Standard. However in Explanatory Guide A5[2] *"Optional Template and Associated Guidance Notes for Applying Public Benefit Entity Simple Format Reporting – Accrual (Not-For-Profit)"* (Called A5) there is an example of straight line and its use within the Tier 3 Standard[3]. While A5 is non-binding and simply a guide, given the absence of a definition within the Tier 3 Standard, it is a starting point.

In that example, there is a motor vehicle whose original cost was $7,500 and its estimated useful life is 5 years and therefore the annual depreciation expense is $7500/5 = $1,500 per year. The residual value of the motor vehicle is not taken into account. While this is simple, it is wrong as it does not take into account the residual value of the motor vehicle after 5 years of use.

There is an option within the Tier 3 Standard to use Tier 2 Standards. Clause 6 of the Tier 3 Standard provides:

"Where this Standard does not provide guidance on a specific type of transaction or event, the entity shall use its judgement to determine an appropriate method of accounting for that transaction type

[1] See Section 11: Glossary of the Public Benefit Entity Simple Format Reporting – Accrual (Not for Profit) accounting standard.

[2] See Explanatory Guide A5 (EG A5) Optional Template and Associated Guidance Notes for Applying Public Benefit Entity Simple Format Reporting – Accrual (Not for profit). This can be downloaded from the XRB website (www.xrb.govt.nz)

[3] See page 39 of EG A5 which looks at Row SoFPer11, "Other Expenses"

that results in the performance report providing relevant and reliable information. The entity shall refer to, and consider the applicability of, the following in descending order:

(a) The principles and requirements in this Standard dealing with similar and related transactions or events; and

(b) The definitions and concepts in the PBE Framework to the extent that they do not conflict with this Standard.

In making the judgement described above, the entity might also consider (but is not required to apply) the relevant requirements in the Tier 2 PBE Accounting Requirements dealing with the same, similar or related transactions or events."

Do we need to Depreciate?

The simply answer is yes we do need to apply a depreciation expense into the financial statements of a Tier 3 entity.

Clause A107[4] provides a table for property, plant and equipment and in that table it provides *"Record depreciation – spread the cost of the asset over the expected useful life of the asset, using a structured method such as straight line or diminishing value."*

What is the Cost to be spread for Buildings?

Key components that require an estimate:

- Initial Cost of the Building
- Expected Life of the Building
- Residual value of the Building

Initial Cost of the Building

In most cases within a Parish the initial cost of the buildings will be deemed to be the rateable value of the building when it was brought into the accounts[5]. The Tier 3 Standard allowed for the transitional arrangements to use the rateable value of land and buildings as a proxy for cost as a onetime entry into the accounts. We will assume that the cost in the accounts is either the actual cost of land and buildings or the rateable value as a proxy for cost.

If you decide to use the revaluation method rather than the cost method, then your initial cost changes. This document assumes that you are using the cost method rather than the revaluation method.

[4] This clause reference refers to Public Benefit Entity Simple Format Reporting – Accrual (Not for Profit) accounting standard.

[5] Clause B5 (b) of Appendix B: Transitional Arrangements of Public Benefit Entity Simple Format Reporting – Accrual (Not for Profit) accounting standard.

Expected Life of the Building

It is expected that the useful life for most buildings within the Church will be for a minimum of 50 years. I believe the evidence would support that view but there are specific situations which may see the useful life of a building being lower or higher than 50 years but in general terms it would not be unreasonable to estimate the useful life of a maintained building to be 50 years and therefore we will adopt that as a starting point.

Having said that, you need to evaluate each building you have and make a determination of the expected life of the building.

Residual Value of Land and Buildings

While the concept of a residual value is not provided in the Tier 3 standard and therefore, according to the wording in the standard, can be ignored we need to use our judgement to allow for the residual value of both land and buildings as this makes practical sense.

The IRD has determined[6], through a qualitative study, that during the period 1993 and 2009, on average, buildings had actually been increasing in value and suggested that the current depreciation rates were not appropriate.

Depreciation Rate

Given the residual value of land and buildings is expected to be higher than the initial cost value, there is no expense to spread over the life of the asset and therefore the correct depreciation rate to apply is 0%.

Impairment

Having said that it is important to note that the Tier 3 reporting entity also be mindful of “impairment”.

Impairment is when an asset is worth less in the market than the carrying amount in the statement of financial position, the difference between the carrying amount and the market value is the impairment value (and is recorded as an expense).

It is unlikely that an impairment event will happen but you need to think about this at each year end. For example, many buildings became impaired after the Canterbury earthquakes, a building that is prone to flooding, etc. If you believe you need to impair a building, ask the Connexional Office for advice.

Accumulated Depreciation

If you have accumulated depreciation for buildings in your accounts then the value of accumulated depreciation will remain in your accounts as it is. We are simply changing the estimated depreciation expenses value from the value you currently have under Accounting Policies (that value could be 2% or 3%) to 0%.

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[6] See reports presented to Parliament relating to The Taxation (Budget Measures) Bill 2010, introduced on 20 may 2010 into Parliament.

Conclusion

Given that the Tier 3 reporting standard requires a reporting entity to estimate depreciation and use their judgement to form a basis for the conclusions reached, the general rate of depreciation to be applied to property for a Tier 3 reporting entity is 0%.

There is an underlying assumption that the property being looked at is in good repair and being maintained. If the property is not being maintained and its expected life is less than 50 years then another approach may be required.