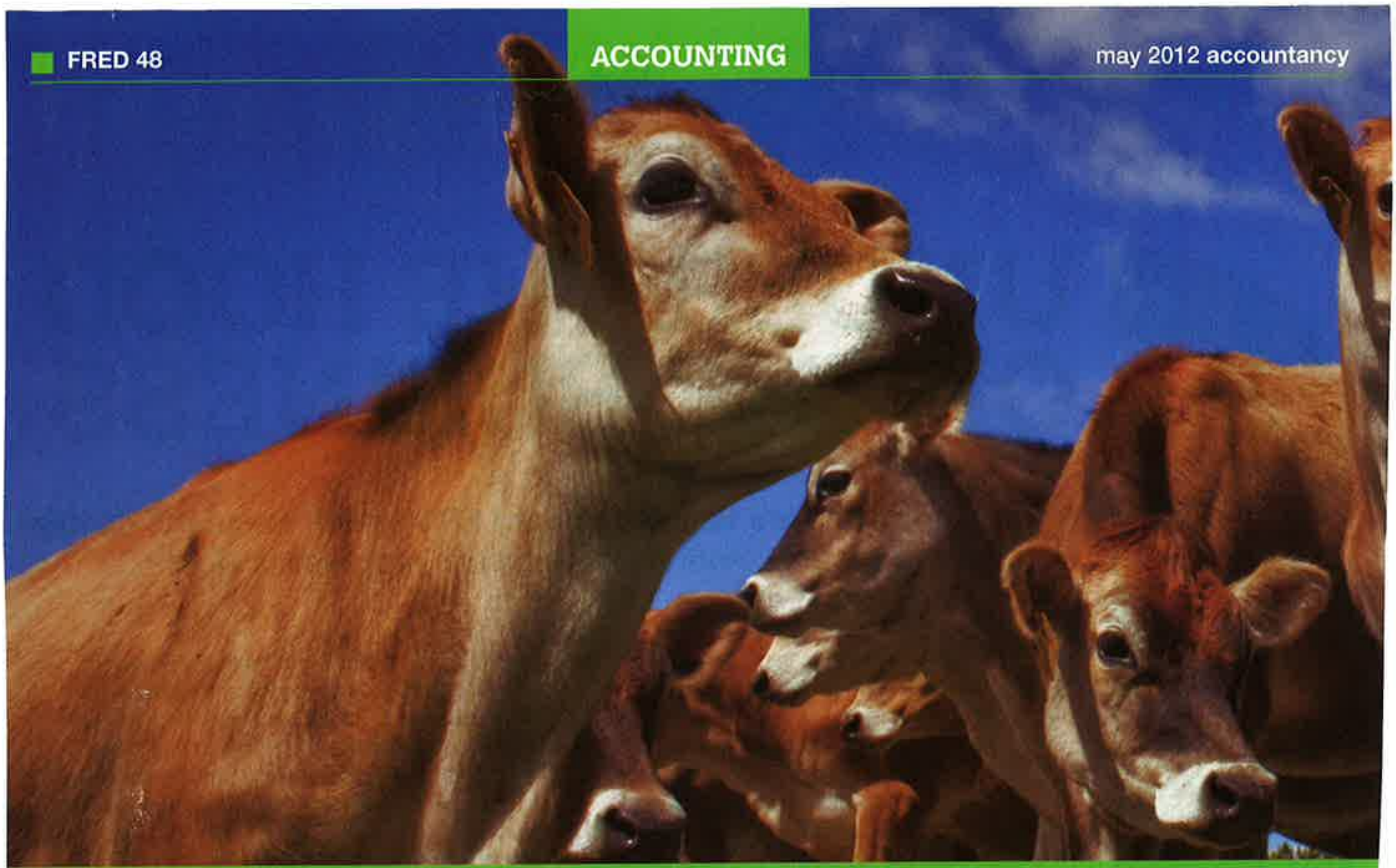


FAIRNESS ON

Unless changes are made when applying FRED 48, farmers will end up with increased tax on their profits, says Julie Butler

FRED 48 is Financial Reporting Exposure Draft number 48, a proposed Financial Reporting Standard (FRS) that, rather boldly, aims to replace all existing financial reporting and accounting standards within the UK. The Accounting Standards Board believes that FRED 48 will provide 'more succinct and understandable financial reporting requirements' than measures currently in place. The aim is that the draft FRS will move the UK and Republic of Ireland towards the single International Financial Reporting Standards (IFRS) framework. Adoption of FRED 48 by the ASB is part of this unifying process.

If approved, FRED 48 and the standards and requirements it lays out would have to be adopted by all registered companies, both private and public, in the UK and Republic of Ireland.

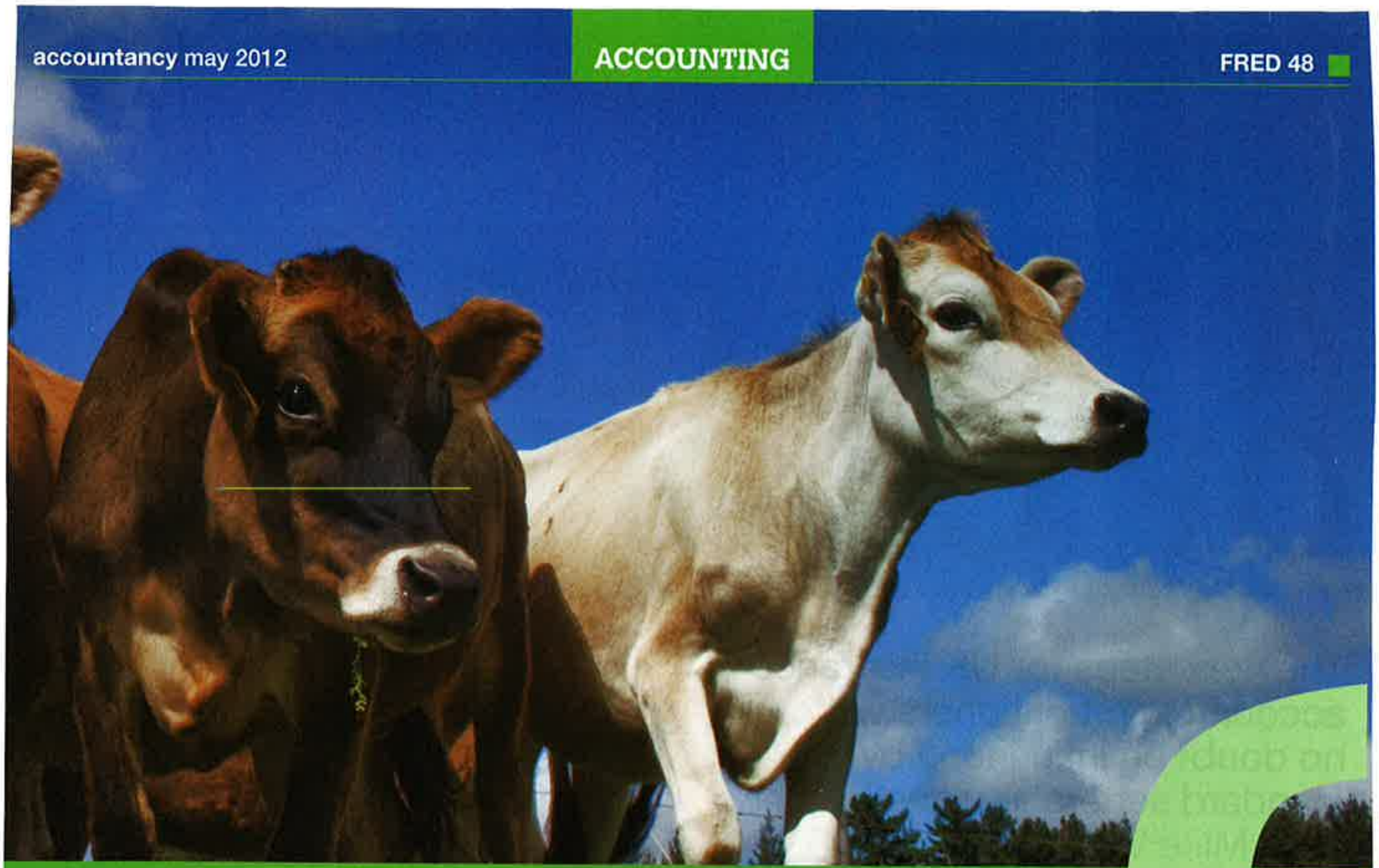
VALUATION IMPACT

One of the changes FRED 48 proposes impacts on how stock is valued. The proposal, in its simplest form, is to value biological assets, including agricultural produce, at 'fair value less cost to sell'. For example, agricultural produce harvested from an entity's biological assets would be measured at its fair value less costs to sell at the point of harvest. Cost would be measured at that date when applying Section 13, *Inventories*, or another applicable section of the FRS. In determining fair value, an entity shall consider: 'If an active market exists for a biological asset or agricultural produce in its present location and condition, the quoted price in that market is the appropriate basis for determining the fair value of that asset. If an entity has access to different active markets, the entity shall use the price existing in the market that it expects to use.'

Currently, the guideline on stock valuation is the lower of cost or net realisable value, and for tax purposes a guideline is published as Help Sheet IR 232, formerly BEN19, and BIM55410. For the majority of farms, therefore, stock valuation is based on calculations as proposed by these help sheets. The deemed cost included in the accounts is therefore 75% of market value for harvested crops, 60% of open market value for cattle and 75% of open market value for sheep and pigs. Currently, most farms are carrying their agricultural produce in the balance sheet, ie, the agricultural stocks, as a much lower figure than fair value. A move to fair values would, therefore, result in an instant increase in the value of stock, an increase in profits reported, and thus lead to an increase in tax calculated on the profits of the farms.

Most of the farming industry in the UK is carried out by small businesses, often in an unincorporated capacity. There would be a distinct taxation advantage to stay unincorporated and to continue using the taxation guidelines for stock valuation. However, a large number of farms are being encouraged to seek limited liability through adoption of Limited Liability Partnerships (LLPs). This would bring them directly within the confines of proposals under FRED 48. Furthermore, many farms are currently looking at the tax advantages given by corporate structuring, including the current fashion for creating 'corporate partners'.

One of the advantages of the corporate entity is the ability to extract profits via dividends without



THE FARM

onerous class 4 NICs. This advantage could be rendered negligible if the ASB approves FRED.

Unless there were to be an adjustment on the tax computation to allow for farming stock to be at the current deemed cost value, a fair value would mean an acceleration of tax payment by the farm business, cash some farms may not have. The current farm valuation BIM55410 was prepared after consultation with HMRC, the Central Association of Agricultural Valuers (CAAV), ICAEW, the Royal Institute of Chartered Surveyors (RICS), Country Land & Business Association (CLA) and National Farmers Union (NFU). Many farmers feel this is a tried and tested method of valuing stock that does not warrant further changes.

CONSIDERATION OF THE 'HERDS BASIS'

The other big agricultural issue with stock valuation is that of 'the herds basis'. This is a possibly obscure but well accepted basis of dealing with stock to help farmers, particularly those building pedigree herds. From a livestock perspective, there would be many individuals who would fight any changes to this tax relief.

Farm animals have the characteristics of machines in that they convert grass into milk or wool. So the herd basis treats animals for production (or reproduction) in the same way as plant and machinery. The herd basis offers potential for tax-free profits but carries risk. This advantage would be lost under FRED 48. The greater the difference between the cost of animals in the herd and final market value, the greater the advantage of the herd basis. There will usually be a useful difference, and thus a tax saving, in the case of a home-bred high quality herd. The herds basis can apply to dairy herds, ewe flocks, pigs, poultry or thoroughbred horses kept for breeding (ITTOA 2005, s142); meaning a large quantity of agricultural businesses would be affected should this valuation method cease.

AGRICULTURAL BALANCE SHEET

The fair value as at the 'quoted price in the relevant market' increases the value from the accepted BIM55410 (BEN19) so it could be argued that such a move strengthens the balance sheet. However, does the farm balance sheet really need such an enhancement at the current time? Ironically, the revaluation of fixed tangible assets is also covered by FRED 48. With farm prices increasing by approximately 100% from 2005 to 2010 and many farm accounts showing very out-dated historical cost, the issue of revaluation of farm freehold property is also important when considering a switch to FRED 48.

The tax disadvantage of fair value with FRED 48 would be a huge factor for the farming community. Different accounting and tax treatments depending on whether a business is incorporated would seem to confuse matters, even though FRED 48 follows much of current UK GAAP logic. It also must be considered that farming businesses will not accept the essentially accelerated profits through changes to requirements for valuing agricultural stocks.

A move to fair values would result in an instant increase in the value of stock, an increase in profits reported, and an increase in tax calculated on profits

JULIE BUTLER FCA
Managing partner, Butler & Co, and a specialist author on agricultural and equine tax issues. www.butler-co.co.uk