

## What FRED 82 means for property development companies

Since key amendments were made to UK GAAP by the Financial Reporting Council (FRC) on 27 March 2024, property companies are set to face significant changes in how they report their financial information. The proposed changes will come into effect on or after 1 January 2026. Early adoption will be permitted provided all amendments are applied simultaneously.

Following detailed feedback on the FRED 82 exposure draft, the new updates to UK GAAP will have sizeable implications for property companies. This article explores the key changes to UK GAAP, what the amendments mean for property businesses, and how you can prepare for the new landscape.

### Key changes you should be aware of

The primary changes to UK GAAP concern the recognition of revenue and lease accounting to align with IFRS 15 and 16 standards.

The new revenue recognition model adopts a five-step approach in line with IFRS 15. This change will also affect micro entities under the FRS 105 standard.

### Revenue recognition

1. **Identifying contracts:** Property development companies are known to have contracts in place with their clients, making this first step simple. However, modifications to contracts should be carefully considered as specific changes are required to be treated as separate contracts.
2. **Identify performance obligations:** Where construction contracts are concerned, services like engineering, procurement, and site clearance are often closely interlinked and do not exist independently. However, there may be cases where multiple obligations exist, in contrast to industries, such as IT, where it is easier to separate goods and services.
3. **Establish transaction price:** Variable consideration would prove to be a complex area for property developers. Businesses must estimate the total amount due if the considerations involve variable amounts. Consideration also has to be given to any late penalties, which may reduce the overall transaction price unless the penalties don't apply.
4. **Allocation of transaction price:** For property companies with single performance obligations, the allocation of transaction prices should be relatively straightforward.
5. **Revenue recognition:** All contracts are required to undertake this assessment and there are no practical exemptions. For property development companies with multiple contracts in place, this could prove to be time-consuming.

### Lease accounting

#### *On-balance sheet model*

The IFRS 16 standard recognises leases as non-current assets on balance sheets. This update removes the distinction between finance and operating leases, forming a 'right-of-use' asset subject to depreciation and interest charges.

#### *Impact on financial statements*

- Under IFRS 16, profit recognition is impacted, with short-term profits potentially increasing as leases are now spread out as depreciation and interest, instead of being recorded directly on profit and loss statements.

However, future profits may decrease as costs are accounted for over the lease term. This shift could impact tax liabilities, banking agreements, and shareholder distributions, making it important for property development companies to adjust their financial strategies accordingly.

- Moving lease expenses off the profit and loss statement results in an increase in EBITDA, as leases are now treated as depreciation and interest costs.
- As a result of leases appearing as both assets and liabilities, gearing ratios will likely rise. Businesses need to assess the effects of higher gearing on their financial ratios as this could impact future investment potential of the company and the perception of the company's financial health.
- The capitalisation of leases under IFRS 16 leads to higher interest charges in the profit and loss statement. This change requires businesses to reassess interest cover ratios and renegotiating with lenders to ensure they meet the new accounting standards.

## **Sector-specific impact**

### ***Property developer***

Profit recognition remains largely unchanged for property developers. However, developers will need to reassess the treatment of leased assets as the capitalisation of leases in relation to development projects will affect financing and profitability analysis.

### ***Builders***

For builders working on long-term projects, IFRS 16's impact on lease accounting must be considered as the new standards will affect how equipment leasing and construction costs. This may also have an effect on profitability and financial reporting.

### ***Architects, engineers, surveyors***

Architects, engineers, and surveyors often manage a mix of fixed price, time charged, and contingent contracts. These companies would need to review the impact of IFRS 16 on revenue recognition and lease accounting, especially for long-term office leases and equipment rentals.

## **Planning for transition**

Property companies should be fully aware of the arrangements under IFRS 16 when preparing for the transition. This means adjusting existing financial reporting processes and systems to comply with the new lease accounting standards. Proactive planning is essential to ensure a smooth transition that minimises disruption to ongoing business operations.

## **Keeping ahead of the change**

The proposed changes brought by IFRS 16 will heavily impact companies within the property and construction industry, which is why it's crucial to start planning now to adapt your financial reporting and strategies to meet the new requirements.

For expert advice, guidance and a detailed review on how to implement these standards successfully, contact Menzies' advisory team.

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