The new UK Financial Reporting regime

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Course Outline

- Background to changes in UK Accounting
- IFRS: Where are we?
- FRS 102

Background to changes in UK Accounting

IFRS users

- Companies quoted on the UK Stock Exchange
- Companies quoted on the Alternative Investment Market (AIM)
- Local Authorities from 2010/11
- All other public sector organisations from 2009/10
- Voluntary users e.g. Subs of overseas groups

UK FRSSE users

- Companies that qualify to use the FRSSE
  - Updated 2008 for CA06 changes
  - Applies to companies where
    - Turnover £6,500k or less
    - Balance Sheet Total £3,260k or less
    - Employees 50 or less
  - Must meet the criteria for two years unless newly incorporated; AND
- Choose to use the option

UK GAAP users

- Any UK organisation:
  - Not required to use IFRS; AND
  - That has not chosen to use the UK FRSSE

Progress on International FRS for SMEs

- Exposure draft two years ago
- IASB believes 95% of Companies are SME's
- Standard published Q3 2009
- Who will it apply to? Entities that:
  - (a) do not have **public accountability; and**
  - (b) publish **general purpose financial statements for external users.**

Examples of external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies.

New UK Proposal

- IFRS for AIM & Quoted
- FRS for companies in middle (UK version of IFRS for SMEs)
- UK FRSSE small co's
- Plus reduced disclosure framework for Parent Company & Subsidiaries where group uses IFRS

The history:
FREDs issued early 2012

- FRED 46 'Application of Financial Reporting Requirements' (draft FRS 100)
- FRED 47 'Reduced Disclosure Framework' (draft FRS 101)
- FRED 48 'The FRS applicable in the UK & Republic of Ireland' (draft FRS 102)

Key facts about the proposals: What is FRS 101?

- Qualifying entities need not disclose:
  - A cash flow statement (IAS 7);
  - Related party transactions between wholly-owned members of the same group (IAS 24); and
  - Selected disclosures from IFRS 1, IFRS 2, IFRS 5,

    IAS 1, IAS 8, IAS 16, IAS 36 and IAS 38.

- Also, qualifying entities which are not financial institutions need not provide the disclosures required by IFRS 7 and IFRS 13.

Key facts about the proposals: What is FRS 102?

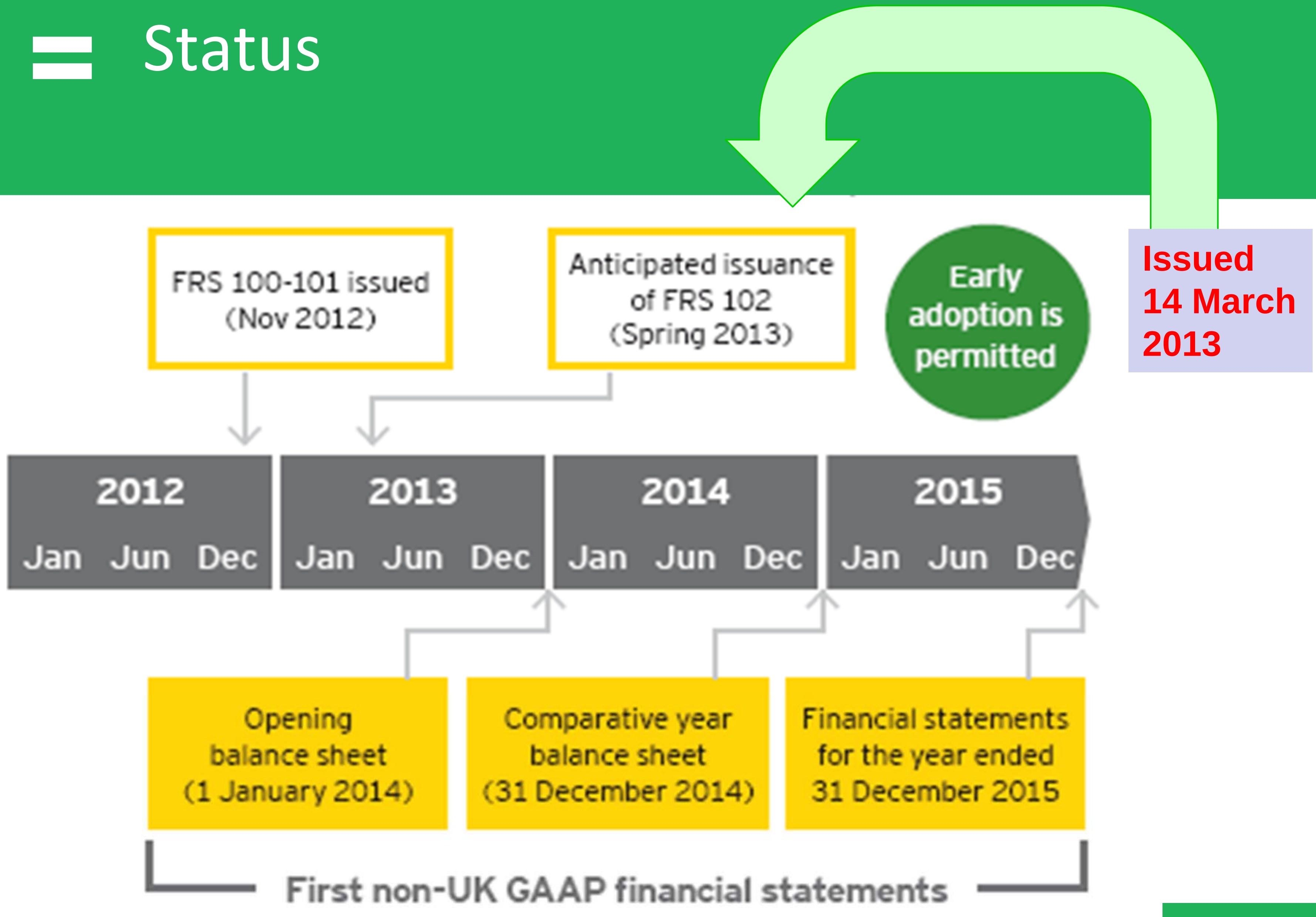
- A standard based on the IFRS for SMEs
- A single standard addressing all areas of accounting
- A relatively short and easy read
- To be updated in three year intervals.

Key facts about the changes

- Amendments made to IFRS for SMEs in preparing FRS 102
  - Application of the guidelines re-introduced a number of accounting options for example:
    - Revaluation of property, plant and equipment
    - Capitalisation of development expenditure
    - Capitalisation of borrowing costs.

Plus many other changes to current UK GAAP

Status



Issued 14 March 2013
FRS 100-101 issued (Nov 2012)
Anticipated issuance of FRS 102 (Spring 2013)
Early adoption is permitted
2012
2013
2014
2015
Jan Jun Dec
Opening balance sheet (1 January 2014)
Comparative year balance sheet (31 December 2014)
Financial statements for the year ended 31 December 2015
First non-UK GAAP financial statements

Quote from FRC

- "FRS 102 modernises and simplifies financial reporting for **unlisted companies** and **subsidiaries of listed companies** as well as public benefit entities such as **charities**. The standard updates UK accounting to take account of evolving business practices. It is succinct, easy to digest and use. Developed with considerable consultation, FRS 102 brings a distinctly British flavour to the international standard for small and medium sized businesses. At around 350 pages the standard replaces close to 3000 pages of UK GAAP."
-

IFRS: where are we?

Users for listed companies (at least)

- EU
- Argentina
- Australia
- Brazil
- Canada
- Mexico
- Korea
- South Africa
- Turkey
- Pakistan

Different approaches

- Canada: uses full IFRS
- Australia: has its own numbered standards that use IFRS text
- EU uses endorsed IFRS, some bits missing on Financial Instruments

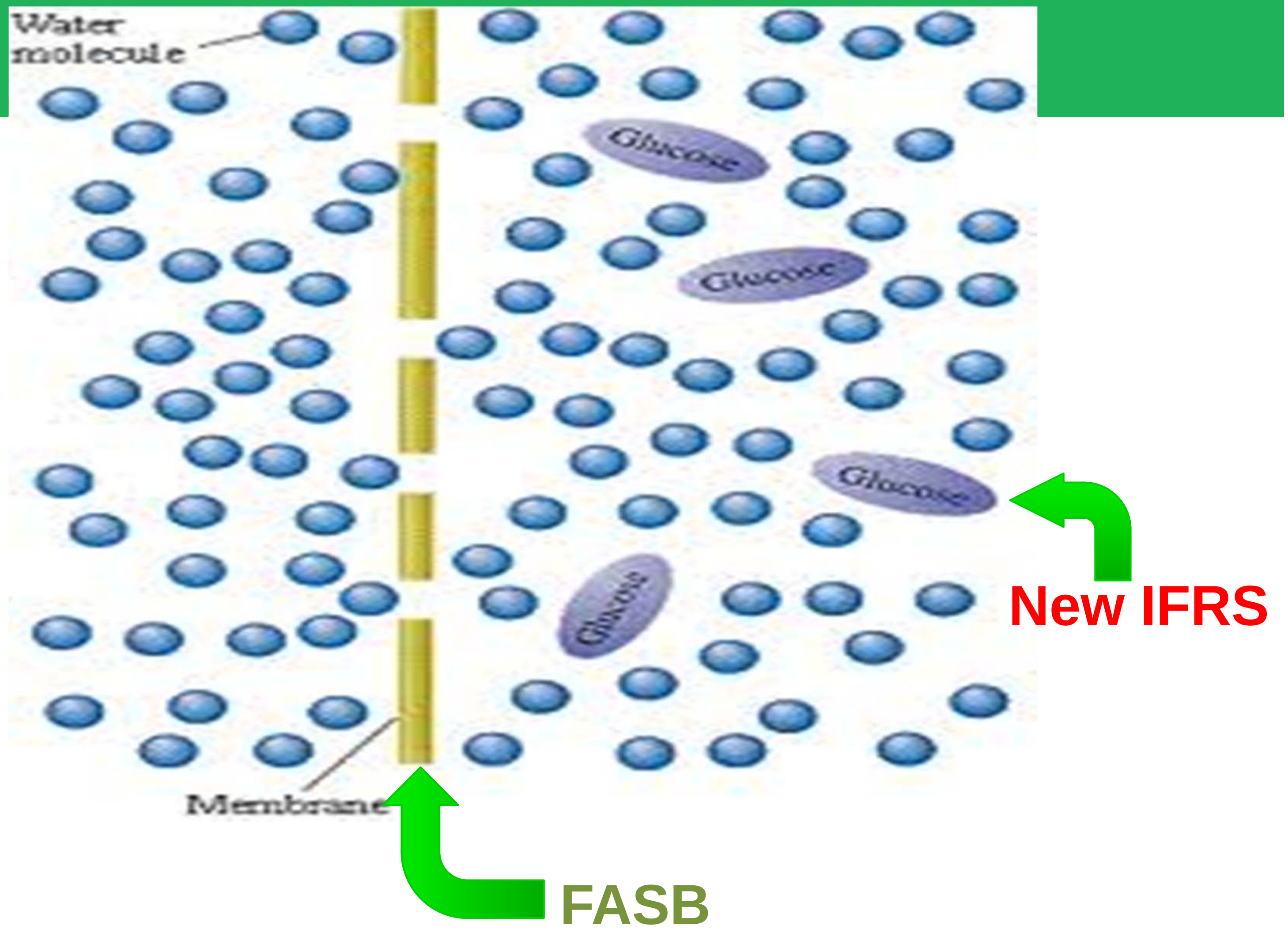
Others

- China: converging national standards
- Japan: allows some listed companies to choose IFRS, delayed until 2015
- India: converging own standards
- Indonesia: converging own standards
- Saudi Arabia: IFRS for banking & insurance cos

What about US?

- SEC looking at this for 10 years
- No prospect in foreseeable future of US companies filing IFRS accounts
- No prospect of voluntary use of IFRS (as would be inconsistent with US GAAP
- Probable way forward is the 'endorsement' model (OSMOSIS)

Osmosis


Water molecule
Glucose
Glucose
Glucose
Glucose
Membrane
New IFRS
FASB

IFRS Current Projects

- Leasing
- Revenue Recognition
- Statement of Principles (Conceptual Framework)
- Pensions changes came in to force on 1 Jan 2013

FRS 102 Overview

Key Changes

- Formats & Terminology
- Employee Benefits
- Tangible Fixed Assets
- Biological Assets & Heritage Assets
- Goodwill & Intangibles
- Deferred Tax
- Groups
- Financial Instruments

Formats & Terminology

- Uses IFRS terminology
- Need to follow CA 2006 formats, even if not a limited company (for anyone that follows 102)
- Statement of Financial Position
- Statement of Comprehensive Income plus Income Statement (1 or 2 statements choice)

Employee Benefits

- Defined Benefit Pensions
- Show one net amount on Balance Sheet
- Measure Liability at discounted NPV
- Measure Asset at Fair Value
- Where there is a Group plan one of the entities needs to recognise the Obligation/Asset in its own accounts; the rest recognise their net obligation to this other company
- Actuarial gains & losses <u>through OCI</u>

Employee Benefits

- Other short term benefits
- Formal requirement to accrue for Holiday Pay
- All benefits expected to be recognised at the value they will be settled at for services accrued in the year
- Termination payments
- Use best estimate at end of year
- Discount if >12 months away

Tangible Fixed Assets

- Requirement for component depreciation
- Allows cost or revaluation (through OCI)
- Formal review of depreciation methods and useful economic lives required where changes occur in technology etc
- Can capitalise borrowing costs

Example

Jarvis Farms Ltd has the following agricultural building that it constructed on its own land:

Cost of building	£440,000

This is a milking shed and there is a milking machine that cost £180,000. The building is built on land with a value of £25,000.

The building will last 30 years, the milking machine will last 10 years.

How will the machine appear in the Statement of Financial Position & Statement of Comprehensive Income?

Solution

Leases

- Operating lease incentives spread over lease term to first break clause under UK GAAP
- Under FRS 102 (& IFRS) these should be spread over whole lease term
- Impact:
  - lower profits under 102 plus lower tax charges
  - Item to carry in Balance Sheet over a longer period

Lease definition

- Very similar to SSAP 21
- Operating Lease & Finance Lease
- Capitalise Finance Lease

Finance Lease indicators

The key indicators are:

- Transfer of title at the end of lease
- Bargain purchase option at end of lease
- Lease term for all or majority of asset life
- PV of minimum lease payments is substantially all value of asset
- Specialised assets that only lessee can use

Biological Assets

- Need to determine a policy for each class of biological asset
- Recognise biological asset when you:
  - Control it
  - Likely to receive economic benefits
  - Can measure FV reliably

Fair Value *or* **Cost** Models

Fair Value Model

- Measure at FV less costs to sell at each accounting date
- Changes to P&L
- Need a market price or some other reliable measure of FV *e.g. there may not be a price per cow but there is a price per kilo of beef*
- In some instances you can use NPV of future cash flows expected from asset

Cost Model

- Measure assets at cost less any accumulated depreciation and impairment
- Any item harvested from the biological asset can then be carried:
    - At the lower of cost & selling price less costs to sell
    - Fair Value less costs to sell (increase to P&L)

May therefore have a tree carried at cost but apples from it at Fair Value

Example

Ambridge Organic Farms Ltd have purchased a herd of rare breed piglets. These beasts were purchased for £3,000 initially. They have been reared using feed of £1,500 to the year end. The beasts will be ready for sale in 12 months from the year end.

The sale price of the pigs fully grown is £12,000. The feed costs for the next 12 months will be £2,000.

The costs of the pig keepers, plus other consumables is £100 per month. The pigs are 9 months old at the year end. Transport & other sale costs are estimated at £800.

What are the valuation options?

Heritage Assets

- Assets maintained principally for their contribution to knowledge & culture
- Use the Cost or Revaluation model
- Recognise separately in the SOFP
- If cost cannot be determined (cheaply) then don't show in SOFP, just disclose
- Review for impairment each year

Goodwill & Intangibles

- Goodwill
  - Amortised over useful life
  - Default period of 5 years
- Other intangibles
  - External purchase
    - Probable economic benefits
    - Cost can be easily measured
  - Internally generated
    - Capitalisation of development expenditure permitted
    - Must then be done consistently

Goodwill

- Requires all Intangible Assets that are:
  - Identifiable; and
  - Measurable

  To be separately recognised
- Goodwill will therefore generally be a lower figure under FRS 102
- There will generally be more scope to use different asset lives

Example

- Benson plc purchases 100% of the share capital of Oyster plc. The Fair Value of the Separable net assets is £15m.
- In addition Oyster has a customer database worth £1.4m & has a patented extraction process integral to its main trade valued at £2.2m
- The price paid by Benson was £23m

- How would this be accounted for under 102?

Solution

Deferred Tax

- Recognised on all Timing Differences subject to exceptions on next slide
- Recognised on Revaluations
- Recognised on business combinations
- Recognised whenever profits of a subsidiary are consolidated (but not yet taxed)
- Use tax rates enacted
- No discounting

Deferred Tax Exceptions

- Assets relating to losses or anything else will only be recognised if reversal is probable
- No need to recognise DT on subsidiary's earnings consolidated if you can control it or if unlikely to reverse in foreseeable future

Example

- Apple acquires Bear on 1 January 2013. At that date there is an upward fair value adjustment on consolidation of £174k to Bear’s Fixed Assets.

- Apple consolidates a profit of £700k from Bear in its 31 March 2013 accounts. Included in Bear’s P&L account was £60k relating to an inter company sale to Apple. The profit was unrealised at the year end.

Groups

- Focus on ability to control
- Transaction costs capitalised (different to IFRS)
- Contingent consideration adjusted to Goodwill (different to IFRS where adjusted to P&L)
- Plus recognition of all intangibles (See above)

Example

- George Holdings plc owns 40% of Black Investments Ltd, a property company. Black Investments is financed by a single loan from George Holdings. The loan is for £5m and the interest payments are at 6% per annum.
- The Operating profits of Black Investments are £550k per annum.

- What is the status of Black Investments in George's accounts?

Financial Instruments

Splits into two types:

- Basic
  - Cash
  - Deposits
  - Accounts receivable & payable
  - Basic loans
  - Non convertible preference shares
- Complex:mainly at FV

Mainly measured at cost
Except:
1. Debt instruments designated at FV
2. Pref shares that are quoted

Financial Instruments

- Can adopt the full IFRS (IAS 39)
- FRS 102 is a simplified version of the above
- Hedge accounting possible under 102 but its use is restricted to:
  - Interest rate risk
  - FOREX risk
  - Commodity price risk (oil etc)
  - Net investment in a foreign operation

- Thank you