UK GAAP Mastercourse

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About your speaker

Steve Collings, FMAAT FCCA is the audit and technical director at Leavitt Walmsley Associates Ltd where he trained and qualified. Steve qualified as a member of the AAT in 2001 and then went on to qualify as a Chartered Certified Accountant in 2005. Steve holds statutory auditor status in the UK and also holds the ACCA's *Diploma in IFRS*, *Certificate in IFRS* as well as ACCA's *Certificate in International Standards on Auditing* and *Diploma in International Standards on Auditing*. Steve also holds the ACCA's *Certificate in IFRS for SMEs*.

Steve is the financial reporting technical editor for AccountingWEB.co.uk and is also an Editorial Board Member for the publisher John Wiley & Sons representing the UK on IFRS related matters alongside Sir David Tweedie. He has written several books on the subject of accounting and auditing, including:

- Interpretation and Application of International Standards on Auditing (Wiley 2010)
- IFRS for Dummies (Wiley 2011)
- Financial Accounting for Dummies (Wiley 2012)
- Corporate Finance for Dummies (Wiley 2012)
- FAQs in IFRS (Wiley 2012)
- Financial Reporting for Unlisted Companies in the UK and Republic of Ireland (Bloomsbury Professional February 2014)

Steve lectures predominantly on auditing, financial reporting and Solicitors Accounts Rules and was awarded *Accounting Technician of the Year* at the 2011 British Accountancy Awards and was also awarded *Outstanding Contribution to the Accountancy Profession* by the Association of International Accountants in 2013. He also contributes a monthly article for the AAT's CPD Interactive website in the Financial Reporting zone.

Introduction

The aim of today's course is to equip delegates with the technical knowledge in respect of major changes that are planned for United Kingdom Generally Accepted Accounting Practice (UK GAAP). With a brand new financial reporting regime comes with it changes to existing accounting practices and this course is designed to give an overview of the following areas:

- The new practices that the new GAAP will introduce (the key differences between existing UK GAAP and new UK GAAP);
- An insight as to how to deal with the transitional issues;
- How the Financial Reporting Standard for Smaller Entities (the FRSSE) has changed as a result of the new regime; and
- The new 'micro-entities' legislation introduced in 2013.

Upon completion of this course, delegates should have the basic knowledge to advise clients and companies on matters related to the new accounting standards and the impact the new regime will have on financial statements.

1. Why the need for change?

1.1 The (now defunct) Accounting Standards Board (ASB) concluded some years ago that UK GAAP, in its current form, had become overly complex in many areas and voluminous. Indeed many practitioners had frequently complained about the sheer volume and extensive disclosure requirements that UK GAAP commands. Many practitioners and commentators have also agreed that UK accounting standards are in desperate need of an overhaul because UK GAAP currently consists of a blend of dated standards that lack cohesive principles, together with additional standards that have merely been adopted from IFRS as well as a failure to keep pace with evolving, and increasingly complex, business transactions.

1.2 The ASB agreed that instead of going back and overhauling existing standards, they would effectively start 'from scratch' and develop a new UK GAAP. The ASB issued FRED 44 *Financial Reporting Standards for Medium-sized Entities* which took the abbreviation the FRSME and which was largely based on the IFRS for SMEs but which had to be tailored in order to comply with UK and EU legal requirements. Other than the proposed changes to comply with legislation, there was very little in the way of changes from IFRS for SMEs to FRSME. There was an element of outcry within the profession following the Exposure Draft, mainly because of the use of the concept of 'public accountability' and the three-tier structure that the Exposure Draft proposed. The three-tier proposal said that only 'non-publicly accountable' bodies could adopt the FRSME which would have meant publicly accountable entities such as pension funds, insurance companies and public sector entities would be required to switch from UK GAAP to EU-endorsed IFRS. Understandably this caused a significant amount of concern within the profession.

1.3 The consultation period ended and it was decided by the ASB that they would essentially take on board the concerns raised and re-issue another Exposure Draft to replace FRED 44. This became FRED 48 (or draft FRS 102) and if approved would replace all FRSs, SSAPs and UITFs with a 250-page standard which would be divided into 35 sections. The revised Exposure Draft:

- Eliminated the tier system for large, small-medium and micro companies.
- Introduced accounting treatments permitted under UK GAAP.
- Incorporated guidance for public benefit entities into FRED 48.

1.4 FRS 100 *Application of Financial Reporting Requirements* and FRS 101 *Reduced Disclosure Framework* were both issued on 22 November 2012. FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* was delayed due to the re-exposure of certain areas of the draft standard, notably in respect of defined benefit pension schemes and service concession arrangements.

1.5 FRS 100 outlines which entities will use which standard. Smaller companies can continue to use the FRSSE and this has been updated for the consequential effects of FRS 102 resulting in the FRSSE (effective January 2015). It is likely that the FRSSE is going to be subjected to further amendments in the future. FRS 101 is basically IFRS, but with reduced disclosure requirements for qualifying entities. The standard outlines the reduced disclosure framework which is available for qualifying entities that report under EU-adopted IFRS.

1.6 FRS 102 is applicable for accounting periods commencing on or after 1 January 2015, with early adoption permissible. Notwithstanding the 2015 effective date, entities which will fall under the scope of FRS 102 will need to think about the impact of FRS 102 earlier as the first balance sheet that will need to be prepared under FRS 102 will be as at 1 January 2014 (assuming a 31 December 2015 year-end). There are also additional disclosures needed in the year of transition.

1.7 The main difference between the old and the revised FREDs is the removal of the three-tier approach to financial reporting. This is replaced by FRS 100 which permits small, unlisted entities to continue to adopt the FRSSE (although the FRSSE is tentatively planned for withdrawal following the EU Accounting Directive). Listed groups will continue to use EU-adopted IFRS and the scope of EU-adopted IFRS will not be extended. All other entities, including Limited Liability Partnerships and not-for-profit entities will choose between FRS 102 and EU-adopted IFRS (although it is likely the vast majority will choose FRS 102).

1.8 The reason the UK and Republic of Ireland standard-setters feel the need to introduce a new reporting regime is because of the fact that UK GAAP is currently outdated, complex and voluminous. In many areas, the requirements are similar to current standards although there are some quite notable differences which will be experienced by the majority of practitioners who will be required to deal with FRS 102.

2. Main differences between FRS 102 and current GAAP

2.1 The good news is that although UK GAAP, in its current form, has become overly complex and voluminous, the (now defunct) Accounting Standards Board (ASB) acknowledged some years ago that it was their intention that the UK will eventually switch to a financial reporting framework that is based on International Financial Reporting Standards (IFRS). This was evidenced some years ago by the fact that when a new IFRS was issued by the International Accounting Standards Board (IASB), the UK took the IFRS, made it compliant with UK legislation and practice and then issued it as a standard. In addition, where significant changes were made to an IFRS, the UK implemented the similar changes after the Exposure Draft had been issued.

2.2 Notwithstanding the similarities between current UK GAAP and FRS 102, there are some notable differences that will affect practitioners and which will need to be thought about before the changes are to take effect in order to assess the impact (particularly the tax impact) for clients.

2.3 The notable changes relate to the following issues:

- Fixed assets
- Investment properties
- Leases
- Cash flow statement
- Employee benefits
- Prior period adjustments
- Revenue recognition
- Deferred taxation
- Defined benefit pension schemes
- Stock valuations
- Accounting policies

2.4 <u>Fixed assets</u>

Current UK GAAP at FRS 15 *Tangible Fixed Assets* goes into a lot of detail concerning the capitalisation criteria for *subsequent expenditure*. As a general rule, FRS 15 requires subsequent expenditure to be written off to the profit and loss account unless the expenditure:

- Provides an enhancement of the economic benefits of the asset in excess of the previously assessed standard of performance.
- Relates to a component of a tangible asset that has been treated separately for depreciation purposes which is replaced or restored.
- Relates to a major inspection or overhaul of the tangible fixed asset that restores the economic benefits of the asset(s) that have been used up by the entity and that have already been reflected in the depreciation charge.

Paragraphs 34 to 41 to FRS 15 go into rather a lot of detail where subsequent expenditure is concerned. However, FRS 102 does not specifically cover subsequent expenditure but merely states at paragraph 17.15 that day-to-day servicing of property, plant and equipment must be recognised in profit or loss in the periods which the costs are incurred. Users would therefore be directed to the *Concepts and Pervasive Principles* in Section 2 of FRS 102 to determine whether any subsequent expenditure does, in fact, meet the definition and recognition criteria of an asset outlined at paragraphs 2.15 (a) and 2.27 (a) and (b).

Paragraph 17.5 to FRS 102 deals with 'spare parts and servicing equipment'. In current UK GAAP these are normally carried in the financial statements as inventory with recognition taking place as and when such parts/equipment are used in the business. FRS 102 at paragraph 17.5 requires 'major' spare parts and stand-by equipment to be included within the cost of the fixed asset(s) to which it relates when the business is expected to use them for more than one accounting period. The main difference here is that FRS 15 does not make specific reference to 'major spare parts/servicing equipment'. The treatment under FRS 102 would essentially mean that the cost of major spare parts/servicing equipment would be recognised within the depreciation charge rather than in the profit and loss account through consumption of stock (cost of sales).

Where fixed assets are acquired under a deferred payment arrangement (in other words deferred beyond normal credit terms), the cost of the asset must be the present value of all future payments in accordance with paragraph 17.13 of FRS 102. Such issues are not specifically covered in current FRS 15 and this would mean that under FRS 15, the value of assets currently capitalised would essentially be under-stated, giving rise to a lower depreciation charge. FRS 102 addresses this issue so the net book value of fixed assets under the new regime would be higher, but this would also have a consequential increase in the depreciation charge, thus reducing profitability or increasing losses.

2.5 Investment properties

SSAP 19 *Accounting for Investment Properties* requires such properties to be classified in the balance sheet at their market value with any changes in this market value going through the revaluation reserve account (i.e. through the statement of total recognised gains and losses).

Paragraph 16.7 of FRS 102 essentially extinguishes the use of the revaluation reserve and requires all changes in fair value to be recognised in profit or loss. The upshot of this treatment would be that reported profit or loss would be different than would otherwise be the case under SSAP 19, although there would not be a tax effect until such time the property was disposed of.

It is also worth noting that FRS 102 requires fair values to be obtained where obtaining such can be done without 'undue cost or effort' whereas SSAP 19 does not make this exception. In FRS 102, if obtaining fair values would result in undue cost or effort, then the entity accounts for investment property in accordance with Section 17, *Property, Plant and Equipment* until a reliable measure of fair value becomes available. In reality, the entity would commission a surveyor to undertake the valuation and it is very difficult to see how obtaining such values for investment property would cause undue cost or effort.

Many practitioners have complained about the way in which Section 16 deals with the fair value changes in investment property. Whilst accounting standards do not give specific reasoning behind their methodologies, investment property is not subjected to depreciation or impairment testing because they are valued at fair value at each reporting date hence any changes in fair value are taken directly to profit or loss. It is also worth pointing out that any fair value gains will NOT be distributable.

2.6 Leases

Current SSAP 21 *Accounting for Leases and Hire Purchase Contracts* sets out a specific numeric benchmark when determining whether a lease is a finance or operating lease as is demonstrated in paragraph 22 to the Guidance Notes in SSAP 21. This benchmark is where the minimum lease payments equate to 90% or more of the fair value of the asset subjected to the lease.

The classification under FRS 102 does not refer to a 90% benchmark, but instead offers examples of the various situations that individually, or in combination, would give rise to a lease being classified as a finance lease. These classifications are as follows:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term.

(b) The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised.

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred.

(d) At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

(e) The leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Three other indicators that the lease could be a finance lease are:

(a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

(b) Gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (e.g. in the form of a rent rebate equalling most of the sales proceeds at the end of the lease).

(c) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

The classification criteria are based upon the risks and rewards of ownership of the associated asset and which party retains those risks and rewards. There are a number of factors that can determine whether risks and rewards have, or have not, been transferred from lessor to lessee and therefore paragraph 20.7 to FRS 102 acknowledges that the examples of indicators contained in paragraphs 20.5 to 20.6 of FRS 102 will not be conclusive in every respect and consideration must therefore be given to other indicators that risks and rewards may (or may not) have transferred from lessor to lessee, thus there could be more judgement needed in this subjective area.

In some cases lessees may receive an incentive payment to take up a lease. Paragraph 20.15 does not make reference to the effect of incentive payments relating to operating leases. In current GAAP, UITF 28 *Operating Lease Incentives* at paragraph 8 states that any incentive should be allocated to match the effect of the increased rentals in later periods so that the financial statements reflect the true effective rental for premises – in other words an incentive is not recognised immediately.

2.7 <u>Cash flow statements</u>

The cash flow statement becomes a mandatory primary statement under FRS 102 and there are no situations exempting companies under the scope of FRS 102 from preparing such a statement.

FRS 1 *Cash Flow Statements* requires a cash flow statement to be prepared using the following standard headings:

- Operating activities
- Dividends from joint ventures and associates
- Returns on investments and servicing of finance

- Taxation
- Capital expenditure and financial investments
- Acquisitions and disposals
- Equity dividends paid
- Management of liquid resources
- Financing

Section 7 of FRS 102 requires the cash flow statement (or 'statement of cash flows') to be prepared using three types of classification:

- Operating activities
- Investing activities
- Financing activities

Operating activities are the day-to-day revenue-producing activities that are not investment or financing activities. This category is essentially a 'default' category, encompassing all cash flows that do not fall within investing or financing classifications.

Investing activities are those activities that involve the acquisition and disposal of long-term assets; for example monies used for the purchase of fixed assets and cash receipts from the disposal of fixed assets.

Financing activities are those activities that change the equity and borrowing composition of the company. For example, if a client issues shares in the year to raise cash, the proceeds from the issue would be a financing activity. Similarly, where a client raises a loan, such proceeds would also be classified as a financing activity.

2.8 Employee benefits

The main issue surrounding this area is the fact that under FRS 102 accruals for holiday pay will have to be made (as is currently not done in practice under current UK GAAP). The difficulty is potentially in the calculation of holiday pay that is to be carried over for future use and pulling this information together for the very first time is likely to be time-consuming and cumbersome, particularly for large organisations where there is no central record of this information.

2.9 Prior period adjustments

This difference in this area relates to error correction. Error correction is dealt with in Section 10 to FRS 102 (paragraphs 10.19 to 10.23). Current UK GAAP deals with error correction in FRS 3 *Reporting Financial Performance*. Paragraph 10.21 of FRS 102 requires an entity to correct a 'material' prior period error retrospectively in the first financial statements which are authorised for issue after discovery of the error by way of a prior period adjustment.

Paragraph 63 to FRS 3 requires the correction of 'fundamental' errors. Fundamental errors are those which are so significant that they destroy the true and fair view of the financial statements as well as the validity of those financial statements.

The terms 'material' and 'fundamental' could be interpreted differently among practitioners, but they do amount to the same thing. This interpretation aspect will mean that more errors will be corrected retrospectively by way of a prior period adjustment.

In practice, however, current UK GAAP is more stringent as the error currently has to be 'fundamental' rather than 'material'.

2.10 Revenue recognition

There are some slight variations in the wording relating to the measurement of revenue. For example in paragraph 23.3, FRS 102 refers to revenue being the fair value of the consideration 'received or receivable'. Application Note G to FRS 5 *Reporting the Substance of Transactions* at paragraph G4 says that a seller recognises revenue under an exchange transaction with a customer, when, and to the extent that, it obtains 'the right to consideration' in exchange for its performance.

This subtle difference in wording could potentially allow for later recognition of profit which would result in a potentially different tax treatment as the tax treatment will follow the accounting treatment.

Paragraph 23.15 to FRS 102 refers to a 'specific act' and a 'significant act'. The paragraph says that when a specific act is much more significant than any other act, the entity postpones revenue recognition until the significant act is executed. UITF 40 (Application Note G to FRS 5) is more prohibitive in that it requires revenue to be recognised in line with performance (passing a 'milestone' or a 'critical event') and earning the right to consideration, hence there is the potential here to the possibility of recognising profit later than would otherwise be the case under UITF 40 principles. This would also have a direct effect on the tax as the tax treatment follows accounting treatment so care must be taken to correctly interpret the requirements.

Paragraph 23.16 of FRS 102 says that if a client cannot estimate the outcome of a service contract (more likely to be the case with construction contracts) then the client should only recognise revenue to the extent of the costs incurred. In contrast, paragraph 10 to SSAP 9 *Stocks and Long-Term Contracts* says that where the outcome of long-term contracts cannot be assessed with reasonable certainty, no profit should be reflected in the profit and loss account and suggests showing as turnover a proportion of the total contract value using a zero estimate of profit.

2.11 Deferred taxation

FRS 102 requires deferred tax to be recognised in respect of all timing differences at the balance sheet date which is similar to the current FRS 19 *Deferred Tax* requirements. However, FRS 102 uses a 'timing difference plus' approach for deferred tax which could result in larger deferred tax balances being recognised because the following will also give rise to deferred tax considerations under FRS 102:

- Revaluations including investment property
- Fair values on business combinations
- Unremitted earnings on overseas subsidiaries or associates

There is also a prohibition in FRS 102 which prohibits an entity from discounting deferred tax assets or liabilities. In practice, hardly any firms discount deferred tax balances to present day values so this prohibition will generally go unnoticed.

2.12 Defined benefit pension schemes

FRS 102 at paragraph 28.18 provides a number of simplifications where the valuation basis (the Projected Unit Credit Method) would require undue cost or effort. FRS 102 does not require the use of an independent actuary to provide a valuation as current UK GAAP at FRS 17 *Retirement Benefits* currently requires. However, the entity must be able to measure its obligation and cost under defined benefit plans without undue cost or effort. Therefore, unless the accountant is a trained actuary, clients will still have to use the services of an actuary to arrive at the valuation required to include the defined benefit pension scheme within the financial statements.

2.13 Stock valuations

SSAP 9 *Stocks and Long-Term Contracts* allows stock to be valued using the 'last-in first-out' (LIFO) method. Whilst this methodology is permissible in SSAP 9, the standard itself does acknowledge that there must be justifiable circumstances for its use.

Paragraph 13.18 follows the same stance as its international counterpart, IAS 2 *Inventories* which outlaws the use of the LIFO method as a basis for inventory valuation.

2.14 Accounting policies

Accounting policies, estimates and errors are covered in Section 10 of FRS 102. Paragraph 10.4 tells financial statement preparers that if FRS 102 does not specifically address a transaction, or other event or condition, an entity's management must develop and apply an accounting policy that is:

- **Relevant** – information is relevant to aid the decision-making process of the users.
- **Reliable** – will result in the financial statements faithfully representing the financial position, performance and cash flows. In addition, the policy must also reflect the economic substance of the transaction(s)/event(s)/condition(s) rather than reflecting the legal form. To achieve reliability the policy adopted must also be neutral, prudent and complete in all material respects.

Currently, FRS 18 *Accounting Policies* is very similar, but in some cases the end result and impact on profit or loss may not necessarily be the same.

2.15 Terminology differences

FRS 102 refers to certain terminology that practitioners maybe unfamiliar with as follows:

Old Terminology	**New Terminology**
Balance Sheet	Statement of Financial Position
Profit and Loss Account	Statement of Comprehensive Income/Income Statement
Statement of Recognised Gains and Losses	Statement of Changes in Equity
Cash Flow Statement	Statement of Cash Flows
Profit and loss reserves	Retained earnings

It is likely that we will witness a 'mix and match' of titles - for example Vodafone has a consolidated Statement of Financial Position, whilst Whitbread has a consolidated Balance Sheet. It is suspected the preference will be to refer to old terminology as these follow Regulations. However, paragraph 3.22 to FRS 102 does permit the use of alternative titles providing such titles are not misleading.

3. Applying FRS 102 for the first time

3.1 Practitioners should be considering transitional issues as a matter of priority. FRS 102 will become mandatory for accounting periods commencing on or after 1 January 2015, but the previous year's comparatives will need restating to be FRS 102 compliant. This will involve going back to the 2013 year-end trial balance and restating amounts to arrive at an opening balance sheet as at 1 January 2014 (for December 2015 year-ends).

3.2 FRS 102 deals with first-time adoption in Section 35. First-time adoption of FRS 102 applies once only.

3.3 When a client chooses, or is required to, report under FRS 102, it must make an explicit and unreserved statement in those financial statements of compliance with FRS 102. Paragraph 35.4 to FRS 102 confirms that financial statements prepared in accordance with FRS 102 are an entity's first such financial statements if, for example, the entity:

(a) did not present financial statements for previous periods;

(b) presented its most recent previous financial statements under national requirements that are not consistent with this FRS in all respects; or

(c) presented its most recent previous financial statements in conformity with EU-adopted IFRS.

An illustration of the *explicit and unreserved* statement of compliance is as follows:

ACCOUNTING POLICIES

Accounting convention and statement of compliance with FRS 102

The financial statements have been prepared under the historical cost convention as modified by the revaluation of certain assets. The financial statements of the company for the year-ended 31 December 2015 have been prepared in accordance with the Financial Reporting Standard applicable in the United Kingdom and Republic of Ireland (FRS 102) issued by the Financial Reporting Council. These are the company's first set of financial statements prepared in accordance with FRS 102 (see note XX for an explanation of the transition).

3.4 A 'complete' set of financial statements are as follows:

(a) a statement of financial position as at the reporting date.

(b) Either:

(i) a single statement of comprehensive income for the reporting period displaying all items of income and expense recognised during the period including those items recognised in determining profit or loss (which is a subtotal in the statement of comprehensive income) and items of other comprehensive income, or

(ii) a separate income statement and a separate statement of comprehensive income. If an entity chooses to present both an income statement and a statement of comprehensive income, the statement of comprehensive income begins with profit or loss and then displays the items of other comprehensive income.

(c) A statement of changes in equity for the reporting period.

(d) A statement of cash flows for the reporting period.

(e) Notes, comprising a summary of significant accounting policies and other explanatory information.

3.5 Comparative information is also required in respect of previous comparable periods for all monetary amounts presented in the financial statements.

3.6 Section 35 outlines the specific procedures for the preparation of financial statements at the date of transition to FRS 102 which are to:

(a) recognise all assets and liabilities whose recognition is required by this FRS:

(b) not recognise items as assets or liabilities if this FRS does not permit such recognition;

(c) reclassify items that it recognised under its previous financial reporting framework as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under this FRS; and

(d) apply this FRS in measuring all recognised assets and liabilities.

3.7 When an entity is considering transitional issues, a key aspect to consider is its accounting policies. Whilst old UK GAAP has been more or less aligned to new UK GAAP, there are some notable changes, for example the prohibition of valuing stock under the last-in first-out method of valuation and also amortising goodwill and intangible assets over a shorter timescale where management cannot attribute an appropriate economic useful life.

3.8 Where the revision of accounting policies are needed due to the transition to FRS 102, any adjustments required as a consequence of transition are recognised within retained earnings (or, if appropriate, another category of equity) as at the date of transition.

3.9 There are a number of exemptions an entity can choose to take advantage of, if it so requires in order that its financial statements can conform to this FRS. These are contained in paragraph 35.10 of FRS 102 and are transcribed below:

Business combinations, including combination of entities or business combinations under common control

A first-time adopter may elect not to apply Section 19 *Business Combinations and Goodwill* to business combinations that were effected before the date of transition to this FRS. However, if a first-time adopter restates any business combination to comply with Section 19, it shall restate all later business combinations.

Share-based payment transactions

A first-time adopter is not required to apply Section 26 *Share-based Payment* to equity instruments that were granted before the date of transition to this FRS, or to liabilities arising from share-based payment transactions that were settled before the date of transition to this FRS. A first-time adopter, previously applying FRS 20 *Share-based Payment* is prohibited from making any amendment on transition to this FRS for share-based payment transactions.

Fair value as deemed cost

A first-time adopter may elect to measure an item of property, plant and equipment, an investment property, or an intangible asset which meets recognition criteria in Section 18 and the criteria in Section 18 for revaluation on the date of transition to this FRS at its fair value and use that fair value as its deemed cost at that date.

Revaluation as deemed cost

A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant and equipment, an investment property, or an intangible asset at, or before, the date of transition to this FRS as its deemed cost at the revaluation date.

Cumulative translation differences

Section 30 *Foreign Currency Translation* requires an entity to classify some translation differences as a separate component of equity. A first-time adopter may elect to deem the cumulative translation differences for all foreign operations to be zero at the date of transition to this FRS (ie a 'fresh start').

Separate financial statements

Where an entity prepares **separate financial statements**, paragraph 9.26 requires it to account for its investment in subsidiaries, associates, and jointly controlled entities either:

(i) at cost less impairment,

(ii) at **fair value** with changes in fair value recognised in accordance with paragraphs 17.15E and 17.15F, or

(iii) at **fair value** with changes in fair value recognised in profit or loss.

If a first-time adopter measures such an investment at cost, it shall measure that investment at one of the following amounts in its separate opening statement of financial position prepared in accordance with this FRS:

(i) cost determined in accordance with Section 9 *Consolidated and Separate Financial Statements*, or

(ii) deemed cost, which shall be previous GAAP carrying amount on that date.

Compound financial instruments

Paragraph 22.13 requires an entity to split a compound financial instrument into its liability and equity components at the date of issue. A first-time adopter need not separate those two components if the liability component is not outstanding at the date of transition to this FRS.

Deferred income tax

A first-time adopter is not required to recognise, at the date of transition to this FRS, **deferred tax assets** or **deferred tax liabilities** relating to differences between the **tax basis** and the **carrying amount** of any assets or liabilities for which recognition of those deferred tax assets or liabilities would involve undue cost or effort.

Service concession arrangements

A first-time adopter is not required to apply paragraphs 34.12 to 34.16 to service concession arrangements entered into before the date of transition to this FRS.

Extractive industries

A first-time adopter using full cost accounting under previous GAAP may elect to measure oil and gas assets (those used in the exploration, evaluation, development or production of oil and gas) on the date of transition to this FRS at the amount determined under the entity's previous GAAP. The entity shall test those assets for impairment at the date of transition to this FRS in accordance with Section 27 *Impairment of Assets*.

Arrangements containing a lease

A first-time adopter may elect to determine whether an arrangement existing at the date of transition to this FRS contains a lease (see paragraph 20.3) on the basis of facts and circumstances existing at that date, rather than when the arrangement was entered into.

Decommissioning liabilities included in the cost of property, plant and equipment

Paragraph 17.10(c) states that the cost of an item of property, plant and equipment includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. A first-time adopter may elect to measure this component of the cost of an item of property, plant and equipment at the date of transition to this FRS, rather than on the date(s) when the obligation initially arose.

Dormant companies

A company within the Companies Act definition of a dormant company may elect to retain its accounting policies for measurement of reported assets, liabilities and equity at the date of transition to this FRS until there is any change to those balances or the company undertakes any new transactions.

Deferred development costs as a deemed cost

A first-time adopter may elect to measure the carrying amount at the date of transition to this FRS for development costs deferred in accordance with SSAP 13 *Accounting for Research and Development* as its deemed cost at that date.

Borrowing costs

An entity electing to adopt an accounting policy of capitalising borrowing costs as part of the cost of a qualifying asset may elect to treat the date of transition to this FRS as the date on which capitalisation commences.

Public benefit entity combinations

A first-time adopter may elect not to apply those paragraphs in section 34 relating to public benefit entity combinations that were effected before the date of this FRS. However, if on first-time adoption a public benefit entity restates any entity combination to comply with this section, it shall restate all later entity combinations.

3.10 On transition to FRS 102, additional disclosures are required in the first financial statements prepared under FRS 102 and these are as follows:

Explanation of transition to FRS 102

The financial statement should disclose how the transition from the previous financial reporting framework to FRS 102 has affected its reported financial position, financial performance and cash flows.

Reconciliations

The first financial statements prepared under FRS 102 must include:

(a) a description of the nature of each change in accounting policy.

(b) Reconciliations of its equity determined in accordance with its previous financial reporting framework to its equity determined in accordance with this FRS for both of the following dates:

   (i) the date of transition to this FRS; and
   (ii) the end of the latest period presented in the entity's most recent annual financial statements determined in accordance with its previous financial reporting framework.

(c) A reconciliation of the profit or loss determined in accordance with its previous financial reporting framework for the latest period in the entity's most recent annual financial statements to its profit or loss determined in accordance with this FRS for the same period.

3.11 If, during the transition, you become aware of errors that have been made under previous UK GAAP, the above reconciliations must distinguish the correction of those errors from changes in accounting policies.

3.12 Where an entity did not present financial statements for previous periods, disclosure of this fact should be made within the first financial statements that conform to this FRS.

4. Micro-entities

4.1 On 1 December 2013, legislation was introduced in the form of SI 2013/3008 *The Small Companies (Micro-Entities' Accounts) Regulations 2013* which was brought in by the European Union with the objective of reducing costs for small and medium-size companies. The legislation is effective for financial years ending on or after 31 December 2013 and where the company's financial statements are filed with the Registrar of Companies on or after 1 December 2013.

4.2 Under SI 2013/3008 a company qualifies as a micro-entity if it meets at least two of the following three conditions:

- Turnover not more than £632,000
- Gross assets (balance sheet total) not more than £316,000
- Average number of employees not more than 10

Example 1

A company with a year-end date of 31 December 2013 and has been trading since 1 April 2013 (i.e. a nine-month accounting period). Are there any additional considerations that the company must take into account if the accounting period is less than one year?

Yes. Where an accounting period is not one year, the turnover figure must be adjusted proportionately. In this case the company will use 9/12 x £632,000 to determine whether the entity qualifies as a micro-entity.

Example 2

A company is the parent of a group of companies and is trying to establish if it qualifies as a micro-entity under the regime.

For companies which are parent companies, the company will qualify as a micro-entity in the financial year only if:

- The company qualifies as a micro-entity in that year;
- The group headed up by the company qualifies as a small group (as defined in Companies Act 2006 section 383(2) to (7)); and
- The company has not voluntary elected to prepare consolidated accounts.

4.3 The important point to emphasise where groups are concerned is that care must be taken in assessing whether each company within the group qualifies as a micro-entity. The exemptions available under the micro-entities regime will NOT be available for subsidiary companies that are included in consolidated financial statements for the year. In addition, the micro-entities regime is not applicable to:

- Investment undertakings;
- Financial holding undertakings;
- Credit institutions;
- Insurance undertakings;
- Charities; and
- LLPs

Companies in Ireland also cannot (at the time of writing these notes) apply the micro-entities legislation, although Ireland is consulting on the regime.

4.4 **Compliance with the true and fair concept**

Financial statements prepared under the Companies Act must give a true and fair view and this concept has been enshrined in legislation for many years. Micro-entities will only be required to disclose minimal amounts of information at the foot of the balance sheet and additional disclosures will not be required thus the accounts are therefore presumed to give a true and fair view as per the legislation applied to micro-entities. The amounts in the financial statements themselves will continue to be prepared under GAAP - it is only the additional disclosures that will not be required, so recognition and measurement issues will continue as normal.

4.5 **Amendments to the FRSSE (effective April 2008) and (effective January 2015)**

On 29 April 2014, the FRC issued revised versions of the FRSSE (effective April 2008) and (effective January 2015) to incorporate the requirements of the micro-entities legislation. For micro-entities only, the revised FRSSEs:

- withdraw the use of the revaluation model for tangible fixed assets.
- Withdraw the choice to measure fixed asset investments at market value.
- Require micro-entities to account for investment properties using paragraphs 6.19 to 6.26 in the FRSSE as opposed to the specific accounting requirements for investment properties within the FRSSE (effective April 2008) at paragraphs 6.50 to 6.53 (i.e. they will be accounted for under the normal fixed asset rules rather than at fair value).

4.6 In their Consultation Document issued on 29 August 2014, the FRC have proposed to issue a separate standard for micro-entities, being the *Financial Reporting Standard for Micro-Entities* (FRSME). The FRSME is going to be based on the recognition and measurement requirements of FRS 102, with the exception of the alternative accounting rules which are essentially prohibited in the micro-entities legislation. The FRC have said that more consistency with accounting treatments will reduce the number of accounting changes necessary as entities grow.

4.7 The definition of a micro-entity is contained in sections 384A and 384B of the Companies Act 2006 and the qualifying conditions are met by an entity in a year which it does not exceed two, or more, of the following criteria:

Turnover	£632,000
Balance sheet total	£316,000
Number of employees	10

4.8 The micro-entities regime is optional and a company that would otherwise qualify to apply the FRSME could choose not to and apply the simplified FRS 102, full FRS 102 or EU-endorsed IFRS (although it is highly unlikely a micro-entity would choose full FRS 102 or EU-endorsed IFRS to prepare its financial statements). Companies in the Republic of Ireland cannot use the micro-entities regime because no legislation currently exists, but this has been consulted on as part of the DJEI Consultation Document.

4.9 The FRSME will be developed from FRS 102 and will be adapted so as to reflect the requirements of the micro-entities legislation but with further simplifications.

4.10 The FRC are planning to simplify the accounting framework for micro-entities in the new FRSME as follows:

- Presentation and disclosure requirements as set out in legislation.
- FRS 102-specific recognition and measurement requirements except for:
  - Financial instruments which will only be measured at amortised or historical cost;
  - No requirement to account for deferred tax (many accountants will rhapsodise this simplification);

- No requirement to account for equity-settled share-based payments prior to the issue of shares;
- Simplified accounting for post-employment benefits. A micro-entity will be able to account for a defined benefit pension plan as a defined contribution plan.
- Withdrawal of the option to capitalise borrowing costs.
- No requirement to apply sections of FRS 102 which will not generally apply to micro-entities (eg Section 19 *Business Combinations and Goodwill*, Section 31 *Hyperinflation* and most of Section 34 *Specialised Activities* (although the sub-section *Agriculture* will be retained)).

4.11 If a micro-entity has derivative financial instruments, the FRSME will not be able to allow these to be accounted for at fair value or require disclosure of the existence and nature of such instruments because the legislation prohibits this (the micro-entities regime does not recognise any provisions of the alternative accounting rules). However, the FRC have mentioned that the FRSME will clarify when a derivative instrument becomes onerous and hence the obligation will be recognised at present value.0

4.12 There are very mixed opinions as to this reduced disclosure regime. Some practitioners are fearful of reduced fees and BIS is of the opinion that micro-entities may well be able to avoid the need for external accountancy and bookkeeping services. There is doubt this will be the case in many circumstances because the requirement to prepare the figures using GAAP is still required and the accounts must still give a true and fair view. There is also the general feeling that many companies would not wish the burden to prepare their own accounts to be placed on them and feel that such a task is best placed with their accountancy firm. In addition, certain third parties may well require additional, non-statutory information (such as banks in arriving at a lending or borrowing facility decision) because of the potential loss of transparency within the financial statements due to the reduced disclosure.

4.13 A sample set of illustrative FULL financial statements showing how the financial statements COULD look like under the micro-entities regime is shown below:

Micro-Entity A Ltd
Directors' Report for the year ended
31 December 2013

<u>Directors</u>
The directors who have served on the board during the year are as follows:

Mr J Smith
Mrs A Smith

This report has been prepared by taking advantage of the small companies' exemption in section 415A of the Companies Act 2006.

Mr J Smith
Director
31 January 2014

Micro-Entity A Ltd
Profit and Loss Account
For the year ended
31 December 2013

	2013 £	**2012** £
Turnover	58,341	69,546
Other income	4	-
Cost of raw materials and consumables	(28,665)	(30,549)
Staff costs	(11,130)	(10,267)
Depreciation and other amounts written off assets	(1,575)	(1,996)
Other charges	(11,660)	(15,149)
Tax	(1,297)	(1,256)
Profit	**4,018**	**10,329**

Micro-Entity A Ltd
Balance Sheet
as at 31 December 2013

	2013		**2012**	
	£	**£**	**£**	**£**
Fixed assets		4,803		5,988
Current assets	6,285		11,754	
Prepayments and accrued income	-		236	
Creditors: amounts falling due within one year	(6,491)		(11,902)	
Net current assets (liabilities)		(206)		88
Total assets less current liabilities		4,597		6,076
Creditors: amounts falling due after more than one year		(4,490)		(5,937)
Net assets		**107**		**139**
Capital and reserves		**107**		**139**

Notes to the financial statements

1. Directors' benefits: advances, credits and guarantees
During the year the company made an advance of £249 to a director of the company in respect of a personal loan. This amount was fully repaid by the year-end.

2. Guarantees and other financial commitments
The company is currently defending itself in a legal claim brought against it by one of its suppliers who are claiming damages for breach of contract amounting to £4,000. No provision has been made in the financial statements for this amount on the grounds that the legal advisers are uncertain as to whether the company will be successful in its defence.

The company had capital commitments contracted, but not provided for, amounting to £1,000.

The company is entitled to exemption from audit under Section 477 of the Companies Act 2006 for the year-ended 31 December 2013. The members have not required the company to obtain an audit of its financial statements for the year-ended 31 December 2013 in accordance with Section 476 of Companies Act 2006.

The directors acknowledge their responsibilities for:

(a)	Ensuring that the company keeps accounting records which comply with the Companies Act 2006; and
(b)	Preparing financial statements which give a true and fair view of the state of the affairs of the company as at the end of each financial year and of its profit or loss for each financial year in accordance with the requirements of the micro-entity provisions.

4.14 The above illustrative full financial statements are only a guideline as to how a micro-entity's accounts MIGHT look under the new regime as (at the time of writing) the FRC have only just begun the consultation on the amendments to the FRSSE. Additional disclosures may be needed in the directors' report relating to political and charitable donations or the company's policy on disabled employees where the average number of employees exceeds 250 but it gives readers' an idea as to how accounts for smaller companies might look very shortly.

4.15 The above illustration assumes that called up share capital has been fully paid. If it had not been fully paid it would be included as 'Called up share capital not paid' in the balance sheet above the fixed assets heading. In addition, the above illustration assumes no provisions for liabilities or accruals and deferred income, both of which would otherwise be shown underneath 'Creditors: amounts falling due after more than one year' and before 'Net assets'.

4.16 It is also worth pointing out that the directors' report of a micro-entity is not required to be filed with Companies House.

5. Key Points to Consider

5.1 Practitioners must start to plan for the transition to FRS 102 as quickly as possible. Whilst the standard is not due to take mandatory effect until accounting periods commencing on or after 1 January 2015 (early adoption is, of course, permissible), it is important that practitioners start to plan for the change now.

5.2 It is important to emphasise that the date of transition to FRS 102 is *not* 1 January 2015 – it is the start of the earliest period presented in the financial statements. To illustrate:

31 December 2015	31 December 2014	1 January 2014
(FRS 102)	(UK GAAP)	(UK GAAP)
		Restate to be FRS 102 compliant

5.3 The 31 December 2015 financial statements are the first ones to be prepared under FRS 102. The comparative year must also be restated as a result because it is not possible to report financial information with the current year prepared under FRS 102 and the previous year prepared under a different GAAP. The date of transition is the start of the earliest period presented in the financial statements (hence 1 January 2014). As the transition date is 1 January 2014, the 2013 closing trial balance will have to be revisited to take into consideration adjustments that will be needed so the accounts are FRS 102-compliance. This could include, among other things:

1. Amortising goodwill over a five-year period.
2. Stock valuation adjustments (where the client may adopt the use of LIFO).
3. Deferred tax considerations.
4. Fair value adjustments.
5. Revaluation reserve reversals.
6. Use of revaluations as deemed cost.

5.4 The transition to FRS 102 will undoubtedly incur additional costs and these costs need to be considered extremely carefully. It may well be that there could be significant work involved in the transition process in order to arrive at an opening balance sheet at the date of transition and extra work will be involved in reconciling profit and equity from old UK GAAP to the new UK GAAP. These are issues that practitioners must take into consideration as accounts production software programmes are not going to be able to do the bulk of the transition work. Indeed extra review work will be needed by firms to ensure that the disclosures required under FRS 102 are correctly made within the financial statements to ensure that the explicit statement of compliance with FRS 102 can be made.

5.5 Practical issues such as whether the accounts production software programme has been updated to take into account the new UK GAAP must also be made. Dialogue should therefore be entered into with software providers to ensure that they, themselves, are ready for the transition to FRS 102 (though it would be surprising if the reputable accounts production software companies are not ready for the transition). Consideration should also be given in instances where FRS 102 is preferred to be adopted early. Will the accounts software programme be ready for early adoption?

5.6 Staff training issues are a fundamental aspect of this transition planning. Certainly key technical members of staff must be up to speed with how the new UK GAAP is going to affect the financial statements and also be familiar with the process involved in converting old UK GAAP financial statements in new UK GAAP. Again, there may be extra costs incurred such as training costs in adopting FRS 102.

5.7 Auditors will also need to ensure their audit programmes are specifically tailored to take into consideration additional audit procedures to confirm that the transition over to FRS 102 has occurred without problems and the procedures they will adopt must ensure that the risk of material misstatement due to errors in the conversion process are reduced to an acceptably low level.

5.8 Discussions with clients should be entered into to explain to them how their financial statements will be affected by the new UK GAAP and why the new UK GAAP has been introduced. Many clients may well object to the additional fees incurred in the first-year and therefore the costs involved in the conversion are something that practitioners must consider at the outset.

6. Overall Summary

6.1 The move from old UK GAAP to FRS 102 is considered to be one of the most (if not *the* most) significant change to occur in the history of UK GAAP. The need for change was acknowledged by the ASB several years ago due to the complexities inherent in old UK GAAP.

6.2 FRS 102 is intended to be much more simplified than old UK GAAP and this simplification is evidenced by the size of FRS 102 compared to old UK GAAP. FRS 102 also includes many of the accounting practices that old UK GAAP included (such as the revaluation of fixed assets).

6.3 It is important to handle the conversion process in a logical and methodical manner. Whilst reputable accounts production software programmes will handle some of the complexities (such as disclosure issues), it is important that practitioners have an awareness of the key technical aspects of conversion (such as the date of transition and arriving at an opening balance sheet as at the date of transition and the reconciliations of equity and profit).

6.4 Disclosures in the first year of transition will need to be carefully scrutinised to ensure that they are accurate and complete (the use of a reputable disclosure checklist is advisable). The disclosure issues should also be carefully scrutinised by auditors where the client is being audited by the firm.

6.5 Auditors will also need to understand the conversion process pertinent to a particular client in order to adopt procedures that will reduce the risk of material misstatement due to the conversion process to an acceptably low level. It is also important that any errors that are noted during the conversion process are distinguished separately from the adjustments needed as a result of conversion to FRS 102.

6.6 Resources are available on the FRC's website to aid practitioners with the transition from old UK GAAP to FRS 102. Member firms are also encouraged to contact their relevant technical advisory departments in the event of difficulty/confusion to assist them. Professional bodies will have a key understanding of the transitional issues faced by practitioners. In addition, other resources such as relevant articles and bulletins can be read well in advance of the date of transition so that practitioners have a sound understanding of, not only the conversion process itself, but also gain an understanding of practical difficulties that they may face during the transitional process.

6.7 The change to UK GAAP is considered to be significant and it is unlikely that there will be any wholesale changes to UK GAAP for at least three years to allow the new regime to become established.

Checklist

In order to assist in the conversion process, we have developed a checklist to ensure that the first-year transition to FRS 102 runs as smoothly as possible. Please note that this checklist is <u>not</u> exhaustive and other issues that are client-specific will need to be considered. This checklist has been developed in recognition of some of the more practical issues that delegates may face during the transition process.

Issue	Write 'Complete' when completed
Have we established the date of transition to FRS 102? The date of transition to FRS 102 is the start of the earliest period presented in the financial statements – e.g. a 31 December 2015 year-end will have a date of transition of 1 January 2014.	
Does the client have goodwill and intangible assets that have not been given a useful economic life or the client cannot arrive at a suitable economic life? If so these intangible assets must be amortised over a five-year period.	
Does the client have investment properties? If so fair value fluctuations are taken to profit or loss for the period under FRS 102.	
Does the client have 'major' spare parts/servicing equipment? If so, these are to be capitalised as part of property, plant and equipment and the cost recognised through depreciation rather than classed as inventory and put to cost of sales.	
Are the depreciation rates disclosed in the accounting policies the actual depreciation rates used in the financial statements?	
Are finance leases appropriately recognised? FRS 102 does not contain a benchmark percentage of minimum lease payments that equate to fair value and therefore the eight criteria in Section 20 must be carefully considered.	
Does the client value stock under LIFO? If so this will need restatement to FIFO or AVCO to be compliant with Section 13.	
Does the client have financial instruments that fall within fair value valuations? If so careful consideration will have to be given to the valuation of these (for example, embedded derivatives).	
Have deferred tax issues been considered in light of the new GAAP? FRS 102 uses a 'timing difference plus' approach which will	

give rise to additional situations where deferred taxation can arise. Care must be taken with deferred tax assets that they are only recognised when there is evidence that the client will make suitable taxable profit in succeeding years to offset the deferred tax asset.	
Have we made accruals for short-term employee benefits (such as holiday pay)?	
Are we satisfied that we have sufficient information and explanations in order to produce the opening balance sheet as at the date of transition to FRS 102?	
Have we agreed the opening balance sheet at the date of transition to FRS 102 and are there any exceptions that need to be corrected? (Note many accounts production systems will throw up exception reports where brought forward balances do not agree).	
Have we reconciled the equity per old GAAP in the opening balance sheet to the equity per new GAAP?	
Have we reconciled the profit reported under old GAAP in the comparative year to the profit per the new GAAP in the comparative year?	
Are we satisfied that the financial statements in the comparative year have been correctly adjusted in accordance with FRS 102 in order to make the explicit and unreserved statement of compliance?	
In the first FRS 102 financial statements have we made an explicit and unreserved statement of compliance with FRS 102 within the accounting policies section of the notes?	
Have we made the additional reconciliation disclosures as required in FRS 102 (reconciliations of equity and profit)?	
Have we adequately reclassified items reported under FRS 1 *Cash Flow Statements* to be compliant with Section 7 of FRS 102?	
Have we used a disclosure checklist in the first year of transition in order to ensure that disclosures are appropriate and complete?	
Are we acting as auditors on these financial statements? If so we will need to tailor our audit procedures accordingly to ensure we reduce the risk of material misstatement due to	

the transition process to an acceptably low level.	
Have we considered the taxation implications of the transition to FRS 102 within the corporation tax computation?	
Have the financial statements been reviewed by an appropriate person to ensure they are complete and technical disclosures accurate?	
Have we identified any further training needs as a result of this conversion? If so have the relevant partner(s) been consulted?	
Have we made disclosure where the client has taken advantage of any of the optional exemptions in Section 35 of FRS 102?	
If errors have been discovered in the transition process, have we separately disclosed these from those adjustments to the financial statements that have been made due to the transition to FRS 102?	