UK GAAP – Preparing for the change

Breakfast Briefing
23 January 2015
Topics

- Overview of new UK GAAP
- FRS 102 and differences with current UK GAAP
- Tax implications of FRS 102
- Next steps
- Summary
Overview of new UK GAAP
Overview: New UK GAAP

**Application of Financial Reporting Requirements**
The overall framework for financial reporting in new UK GAAP

**Reduced Disclosure Framework**
The reduced disclosure framework for qualifying entities

**The Financial Reporting Standard applicable in the UK and Republic of Ireland**
Introduces a single standard based broadly on the IFRS for SMEs

**Insurance Contracts**
The accounting and reporting requirements for entities issuing insurance contracts
Overview: FRS 102

The financial reporting standard applicable in the UK & Ireland

Replaces all FRSs, SSAPs and UITF abstract

A single standard broadly based on IFRS for SMEs

Sets out the recognition, measurement and disclosure requirements

Effective for accounting periods beginning on or after 1 January 2015
Overview: How will it affect you?

- No change where an entity is required to prepare financial statements using EU-adopted IFRS
- If an entity is eligible to apply the FRSSE, and chooses to do so, then it may continue to do so .... for now
- However, the options available under the new regime are:

<table>
<thead>
<tr>
<th>Entity type</th>
<th>FRSSE</th>
<th>FRS 102</th>
<th>EU-adopted IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible for small companies regime</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Not small and not required to apply EU-adopted IFRS</td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Required to apply EU-adopted IFRS</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>
Overview: When will it happen

- Accounting periods beginning on or after 1 January 2015
- The transition date is the beginning of the earliest period presented
  - for December year-ends, the transition date was 1 January 2014 (*which has already passed!*)

<table>
<thead>
<tr>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepare / file <strong>old</strong> UK GAAP financial statements</td>
<td>Prepare / file <strong>old</strong> UK GAAP financial statements</td>
<td>Prepare / file <strong>new</strong> UK GAAP financial statements</td>
</tr>
<tr>
<td>Restate balance sheet</td>
<td>Restate financial statements in full</td>
<td>Provide disclosures of transition</td>
</tr>
</tbody>
</table>
Overview: FRSSE 2015 and beyond

Current status

• Eligible small companies can choose to apply the FRSSE (2015) rather than FRS 102 from 1 January 2015

• FRSSE (2015) was updated to reflect FRS 102 requirements and changes in legislation (i.e. micro-entities)

Future of the FRSSE

• The shelf life of the FRSSE is likely to be limited

• FRC proposes to replace the FRSSE with Section 1A of FRS 102 for accounting periods beginning on or after 1 January 2016

• Uncertainty remains on whether transition provisions will be made available
FRS 102: differences with current UK GAAP
FRS 102: Key differences

There are a number of important and challenging differences between FRS 102 and current UK GAAP

The key differences are:

1. Presentation of the financial statements
2. Financial instruments
3. Business combinations
4. Intangible assets and goodwill
5. Leases
6. Employee benefits
7. Investment properties
FRS 102: Presentation of the financial statements

Summary of the changes

- FRS 102 uses IFRS terminology (i.e. Statement of Financial Position) - however, entities can continue to use existing terminology (i.e. Balance Sheet). But, whatever terminology is used, it must be applied consistently.

- No change to the format of the Balance Sheet and Profit & Loss Account - the financial statements must follow the Companies Act formats.

- Significant change in the Cash Flow Statement format – follows IFRS: operating, financing and investing activities and reconciles ‘cash and cash equivalents’.

## FRS 102: Presentation of the financial statements

### Comparison of the primary statements

<table>
<thead>
<tr>
<th>FRS 102</th>
<th>Current UK GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of financial position</td>
<td>Balance sheet</td>
</tr>
<tr>
<td>Income statement</td>
<td>Profit and loss account</td>
</tr>
<tr>
<td>Statement of comprehensive income</td>
<td>Statement of total recognised gains and losses</td>
</tr>
<tr>
<td>Statement of changes in equity</td>
<td>Reconciliation of movements in shareholders funds</td>
</tr>
<tr>
<td><em>This is a primary statement</em></td>
<td><em>This could be shown as either a primary statement or a note to the accounts</em></td>
</tr>
<tr>
<td>Statement of cash flows</td>
<td>Cash flow statement</td>
</tr>
</tbody>
</table>

Can be combined into one primary statement
FRS 102: Presentation of the financial statements

Cash flow statement

- Group exemptions to prepare a cash flow statement have changed
  - FRS 1: subsidiaries where the parent held at least 90%
  - FRS 102: only qualifying entities

- Format of the statement differs:

<table>
<thead>
<tr>
<th>FRS 102</th>
<th>FRS 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reconciles movement in cash and cash equivalents</td>
<td>Reconciles only cash</td>
</tr>
<tr>
<td>Three headings</td>
<td>Nine headings</td>
</tr>
<tr>
<td>Starts from profit for the year</td>
<td>Starts from operating profit</td>
</tr>
</tbody>
</table>
FRS 102: Financial instruments

Overview

• A significant change compared to the existing UK GAAP requirements

• Two chapters in FRS 102 on Financial Instruments
  o Section 11 Basic Financial Instruments (e.g. debtors, creditors & simple loans)
  o Section 12 Other Financial Instrument Issues (e.g. forward contracts, derivatives)

• Classification of financial instruments as either ‘basic’ or ‘other’ is dependent upon specific rules

• Accounting policy choice regarding recognition and measurement requirements: adopt either FRS 102 (sections 11 and 12) or IAS 39/IFRS 9

• Disclosure requirements of FRS 102 and Companies Act apply regardless of recognition and measurement choice
## FRS 102: Financial instruments

### Classification examples

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Class</th>
<th>Initial measurement</th>
<th>Subsequent measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade debtor / Trade creditor / Cash at bank</td>
<td>Basic</td>
<td>Cost</td>
<td>Amortised cost</td>
</tr>
<tr>
<td>Bank loan with basic terms (e.g. repayable 2020 at LIBOR +1% )</td>
<td>Basic</td>
<td>Cost</td>
<td>Amortised cost</td>
</tr>
<tr>
<td>Investment in shares (exc. subsidiaries / associates) (e.g. 100 ordinary shares in X plc)</td>
<td>Basic</td>
<td>Cost</td>
<td>Fair value through profit or loss (FVTPL)</td>
</tr>
<tr>
<td>Investment in debt with complex terms (e.g. 100 convertible bonds in Y plc)</td>
<td>Other</td>
<td>Cost</td>
<td>FVTPL</td>
</tr>
<tr>
<td>Bank loan with “complex” terms (e.g. interest payments linked to the UK Land Registry House Price Index +3%)</td>
<td>Other</td>
<td>Fair value</td>
<td>FVTPL</td>
</tr>
<tr>
<td>Derivatives (e.g. interest rate swap or forward foreign currency contracts)</td>
<td>Other</td>
<td>Fair value</td>
<td>FVTPL</td>
</tr>
</tbody>
</table>
**FRS 102: Financial Instruments**

**Intercompany loans**

- Loans to and from subsidiaries are most likely to be classified as basic financial instruments

<table>
<thead>
<tr>
<th>Initial measurement</th>
<th>Subsequent measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of future payments discounted at a market rate of interest for a similar debt instrument</td>
<td>Amortised cost using the effective interest method which results in an interest charge being recognised over the life of the loan</td>
</tr>
</tbody>
</table>

- Zero - coupon loans will need to be accounted for in the same method
  - Recreate the value of existing loans from the date of inception so as to establish an amortised cost at transition
  - Consider the market rate of interest at the inception date
FRS 102: Business combinations

• Merger accounting still exists but can only be used in certain situations

• Most business combinations will be recognised under acquisition accounting

• Key difference: identification of intangible assets arising from the business combination

FRS 102
Greater recognition of intangible assets - only dependent on being able to measure them reliably at fair value - there is no ‘separability’ requirement

Current GAAP
Relatively rare recognition of intangible assets - largely due to the requirement that they must be capable of being disposed of separately without disposing of a business of the entity
FRS 102: Intangible assets and goodwill

- Indefinite useful economic life (UEL) has been removed – all goodwill and intangible assets **must have a finite life**

- Entities must attribute a reliable estimate to the useful economic life
  - Where no reliable estimate can be determined, FRS 102 mandates a **maximum of 5 years** *(but this may change to 10 years)*

- If an entity has previously determined that 20 years is a **reliable estimate** of UEL for goodwill/intangible assets, then there is no requirement to change this under FRS 102 (unless circumstances have now changed)

- Must consider the UEL and residual values of all assets annually
# FRS 102: Leases

<table>
<thead>
<tr>
<th></th>
<th>FRS 102</th>
<th>Current UK GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Classification</strong></td>
<td>No 90% rule</td>
<td>“90% rule”</td>
</tr>
<tr>
<td></td>
<td>Classification depends on the substance of the transaction rather than the form of the contract</td>
<td>Transfer of risks and rewards presumed where present value of minimum lease payments amounts to 90% of the FV of the leased asset</td>
</tr>
<tr>
<td><strong>Initial recognition (finance leases)</strong></td>
<td>Lower of fair value of the leased asset or the present value of the minimum lease payments</td>
<td>Present value of the minimum lease payments</td>
</tr>
<tr>
<td><strong>Lease incentives</strong></td>
<td>Spread over lease term on a straight line basis (unless another systematic basis is more representative)</td>
<td>Spread over period to next rent review on a straight line basis (unless another systematic basis is more representative)</td>
</tr>
<tr>
<td><strong>Operating lease disclosure</strong></td>
<td>Total future minimum lease payments</td>
<td>Annual amount payable categorised by year of expiry</td>
</tr>
</tbody>
</table>
FRS 102: Employee benefits

Holiday pay accrual

- Where ‘accumulated absences’ are material – an accrual must be recognised in the financial statements

- There was no explicit requirement to accrue for holiday pay within existing UK GAAP

- In order to calculate the accrual, the following information will be required:
  - Annual leave year-end compared to the reporting year-end
  - The policy on carrying forward annual leave entitlement
  - Records showing staff entitlement to annual leave at year-end
FRS 102: Employee benefits

Defined benefit pension schemes

• Expected return on plan assets and interest costs will be replaced by a single charge to profit and loss

• Presentation of the scheme deficit in the Balance sheet will change – now shown within ‘other liabilities’

Group defined benefit pension schemes

• Exemption under FRS 17 to only show within in the group accounts is removed

• Individual group entities have to recognise their share of the assets, liabilities and cash contributions (where a contractual arrangement is in place)

• If no contractual arrangement/accounting policy, must disclose who is legally responsible for the scheme
FRS 102: Investment properties

• Group exemption removed – where properties are leased to group companies, they are now within the definition of an investment property.

• Properties held under an operating lease – may be classified as an investment property.

• Investment properties must be held at fair value – unless there is undue cost or effort to obtain a fair value (*unlikely to be the case if obtained in the past*).

• All gains and losses go through profit and loss (not reserves):

<table>
<thead>
<tr>
<th>FRS 102</th>
<th>Current UK GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revaluation movements through Profit and Loss</td>
<td>Revaluation movements through STRGL to separate revaluation reserve</td>
</tr>
</tbody>
</table>
It is possible that FRS 102 will impact the results for the year:

- **Fair value**: more items can, or must, be measured at fair value (e.g. financial instruments)
- **Defined benefit schemes**: expected return on plan assets and interest costs are replaced with a single charge to the profit and loss account
- **Leases**: lease incentives are spread over the lease term and recognition of assets and liabilities where operating leases are re-classified
- **Recognition of assets**: recognition of certain items, such as intangible assets in business combinations, may change
FRS 102 - tax implications
FRS 102: Tax implications

New FRS – Tax impacts – in year

• FRS 102 brings no new specific tax issues, but if computed profits change under new accounting rules, taxable profits may follow in line

• Exceptions arise where specific tax rules apply

• Deferred tax

• Be aware of risk that taxable profits could increase without additional cashflow
FRS 102: Deferred tax

Whilst FRS 102 is based on the same core methodology as current UK GAAP, there are some key differences:

1. Deferred tax is now recognised on:
   - revaluation of properties (including investment properties) and other revalued assets
   - the difference between tax and fair value of assets and liabilities (other than goodwill) acquired under business combinations
   - unremitted earnings from overseas entities

2. Discounting of deferred tax assets and liabilities is no longer allowed
**FRS 102: Deferred tax - Example**

Deferred tax on acquisitions is adjusted against the goodwill balance

<table>
<thead>
<tr>
<th>Acquisition of 100% subsidiary</th>
<th>£k</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration</td>
<td>1,500</td>
</tr>
<tr>
<td>Fair value of net assets</td>
<td>1,200</td>
</tr>
<tr>
<td>Goodwill</td>
<td>300</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deferred tax calculation</th>
<th>£k</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of net assets</td>
<td>1,200</td>
</tr>
<tr>
<td>Tax written down value of net assets</td>
<td>(870)</td>
</tr>
<tr>
<td>Difference</td>
<td>330</td>
</tr>
<tr>
<td><strong>Deferred tax @ 20%</strong></td>
<td>66</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Adjustment to goodwill</th>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>66</td>
<td></td>
</tr>
<tr>
<td>Deferred tax</td>
<td></td>
<td>66</td>
</tr>
</tbody>
</table>
FRS 102: Tax implications

Often overlooked is the impact that the PYA could have on income and tax

- If brought forward profits are restated;
- And the restatement arises on an income/expense source that would have been taxable (e.g. Turnover recognition)
- Then the increase in profits is taxable in the first year of the new accounting policy.
- Potential for more significant impact on tax charge (with no cash resource change) than the in year changes.
- If the initial accounting policy was wrong – the previous returns were wrong.
Next steps
Next steps: Summary

• Consider which standard to adopt sooner rather than later: mitigate the risk of unintended consequences or cost

• Identify an individual to lead the transition project: information will be required from a number of sources

• Undertake a gap analysis to identify accounting policies that require change: PKF Littlejohn can provide assistance (more later)

• Prepare an implementation timeline: prioritise the more challenging areas in FRS 102 and remember the comparatives

• Consider the transition exemptions: section 35 of FRS 102 includes details of the exemptions available on first-time adoption which can ease the transition burden
Next steps: Operational matters (1)

<table>
<thead>
<tr>
<th>Area</th>
<th>Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank covenants</td>
<td>Profits before and after tax, interest charges and income and balance sheet amounts may be different under FRS 102</td>
</tr>
<tr>
<td></td>
<td>Need to understand the impact on covenant calculations and discuss the implications with lenders / finance providers</td>
</tr>
<tr>
<td>Profit related bonus payments</td>
<td>Profit and loss may now include more gains and losses that do not equate to cash (e.g. revaluations of investment properties)</td>
</tr>
<tr>
<td></td>
<td>Need to review existing arrangements and consider whether any changes are required.</td>
</tr>
<tr>
<td>Distributable profits</td>
<td>Not all adjustments will affect realised profits and losses</td>
</tr>
<tr>
<td></td>
<td>Need to liaise with investors regarding the impact on distributable profits and dividend planning</td>
</tr>
</tbody>
</table>
## Next steps: Operational matters (2)

<table>
<thead>
<tr>
<th>Area</th>
<th>Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax</strong></td>
<td>Speak to our tax team before:</td>
</tr>
<tr>
<td></td>
<td>• Making accounting policy choices</td>
</tr>
<tr>
<td></td>
<td>• Entering into major transactions or financing arrangements</td>
</tr>
<tr>
<td><strong>Internal processes and accounting systems</strong></td>
<td>Consider:</td>
</tr>
<tr>
<td></td>
<td>• whether additional resources are needed</td>
</tr>
<tr>
<td></td>
<td>• what training is required for all relevant staff in the company</td>
</tr>
<tr>
<td></td>
<td>• if new data is required to be captured or data needs to be captured differently under FRS 102</td>
</tr>
<tr>
<td></td>
<td>• whether changes to the accounting systems will be needed in order to prepare the financial statements under FRS 102</td>
</tr>
</tbody>
</table>
Next steps: Guidance and assistance

Financial Reporting Council


How we can help

PKF Littlejohn can assist in the following areas

• Gap analysis

• Staff training
Next steps: PKF Littlejohn Gap analysis

How can we help?

• We can guide you through the transition to FRS 102 through the use of our FRS 102 assessment tool

• We will identify the options available, including exemptions, and help you make the right decisions

• The impact of FRS 102 is clearly highlighted in the report through a ‘traffic light’ grading so you can easily see the priority areas

• We will discuss the findings of the report with you and can offer assistance with any further steps that may be required
Summary
Summary

Transition to FRS 102 will change not only the format of, and disclosures in, financial statements but also:

- the criteria for recognition of some assets and liabilities
- the measurement basis of some items
- the treatment of some gains and losses

There will also be implications beyond the financial statements that require consideration ranging from the impact on covenants to operational matters.

Proper planning is key
Transition may take longer than you think!
Questions
This seminar and the accompanying handouts cover topics only in general terms and are intended to give a wide audience an outline understanding of issues relating to accounting applicable to entities in general, and therefore cannot be relied upon to cover specific situations; applications of the principles would depend on the particular circumstances involved. Furthermore, responses given in the seminar to questions are only based on an outline understanding of the facts and circumstances of the cases and therefore do not form an appropriate substitute for considered specific advice tailored to your circumstances. We recommend that you obtain professional advice before acting, or refraining from acting, on any of the contents. We would be pleased to advise you on the application of the principles demonstrated at the seminar, or on any other matters, to your specific circumstances, but in the absence of such specific advice, we cannot be responsible or held liable.

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