Changes in financial reporting

What clients should know

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Important changes are being made to UK GAAP by Financial Reporting Standards 102 to 105.
FRS 102 is mandatorily effective for non-small entities for periods commencing on or after 1 January 2015. FRS 105 (for qualifying micro-entities) and a revised FRS 102, applicable to small entities, will be effective for periods commencing on or after 1 January 2016. Earlier adoption is permitted in all cases. In **Changes to financial reporting: The time to act is now**, we provided an overview of the considerations that you need to think about now. In this commentary we look at some of the key differences, issues and implications that clients should be aware of as a result of implementing New UK GAAP.

Assessing the Impact of new UK GAAP

Clients must be prepared for changes arising on first implementation of new UK GAAP as:

- reported profits could change;
- the balance sheet position could be significantly affected;
- there are opportunities on transition; and
- accounts will look different.

Your communication regarding these changes will need to be timely, relevant and tailored to your client's circumstances as the precise impact of the new standards will differ from one client to another. For some, the impact could be minimal, for others the devil will be in the detail!

Some of the areas that clients need to be aware of to enable the impact of the new standards to be assessed are highlighted below.

Reported profits could change

Recognition of fair value movements

Changes to the way that certain fair value movements are presented could have a significant effect on reported profits.

Currently, for example, investment properties are required to be revalued each year to open market value with movements being reflected in reserves. FRS 102 requires the revaluation each year to fair value (essentially the same as open market value) but with the changes in value being taken to profit or loss.

Revaluation gains on investment properties will boost the reported profit, though will neither be subject to tax nor form part of the distributable profits.

Revaluations, however, are not permitted for micro-entities reporting under FRS 105.

Timing of gains and losses

FRS 102 requires certain other items to also be measured at fair value, with changes being reflected in the profit or loss for that period. Under old UK GAAP, any gains or losses on such items were generally identified at end of the contract for example. Affected areas include:

- investments (other than in subsidiaries, associates and joint ventures);
- forward exchange contracts; and
- futures and interest rate swaps.

FRS 102: The Financial Reporting Standard applicable in the UK and Ireland

Overview

FRS 102 is a single standard that replaces existing UK GAAP for entities that are not entitled to report as small (or choose not to) and are not required to report under IFRS, for periods commencing on or after 1 January 2015, with early adoption permitted.

Small entities and FRS 102

The FRSSE is removed for periods ending on or after 1 January 2016, bringing small companies within the scope of FRS 102. At the same time, a new, simplified financial reporting standard applicable to micro-entity companies (FRS 105) has been introduced.

FRS 102 also requires lease incentives to be spread over the term of the lease rather than to the date when the rent is next reviewed (normally when there is a break clause) - for both landlord and tenant. This can make a significant difference to the timing of recognised gains and losses.

Other accounting differences

Other changes affecting reported profits include the requirement to accrue for holiday pay and the amortisation of goodwill and other intangibles.

FRS 102 requires that intangibles (including goodwill) are amortised over their useful life (there will be no cap at 20 years), but to be able to justify where the life is more than ten years. On transition this could lead to some large amounts being written-off goodwill.

Assessing the impact

Clients will need to assess the impact of changes affecting their reported profits and communicate to affected stakeholders. Where entities pay bonuses out of profit or have profit-related pay schemes, the basis of these calculations should be reconsidered.

Also, with FRS 102 adopters seeing changes in fair value reflected in the profit or loss for the period, entities will need to take more care when determining taxable profits and companies will need to ensure that dividends are paid out of distributable profits.

Finally, as FRS 102 requires more items to be included at fair value in the accounts with movements reflected in the profit and loss account, entities will need to establish whether their budgets and management accounts should reflect these movements or whether they will be dealt with as period end adjustments only.

The balance sheet position could be significantly affected

Recognition and classification of assets (and some liabilities)

The new standards have slightly different definitions of what constitutes certain tangible and intangible assets. Furthermore, specific definitions for, and treatment of, financial assets and liabilities are set out for the first time.

Investment properties

The definition of an investment property is widened within FRS 102. Specifically, owner occupied properties and properties let to other group companies are no longer excluded from being treated as investment properties.

This could mean that some properties currently included as property, plant and equipment will need to be reclassified as investment properties.

Deferred tax

Deferred tax under FRS 102 is based on the same timing differences approach as current UK GAAP, but also requires deferred tax to be recognised on items such as the revaluation of investment properties and certain other assets.

Apart from the changes being likely to make the calculation of deferred tax more complex and give rise to deferred tax in more situations, the balance sheet position of affected entities could be negatively impacted through the recognition of new deferred tax liabilities.

Deferred tax, however, will not be accounted for at all by micro-entities reporting under under FRS 105.

Intangible assets and goodwill

The FRS 102 criteria for recognition of intangible assets is broadened to include those which are identifiable and measurable. This is particularly important on the acquisition of a business. Currently some intangibles may not be identified separately and therefore the amount of goodwill is shown as an eclectic mix of intangibles.

With the change of definition, more individual intangibles are likely to be identified and, in consequence, the amount of goodwill will be a lower figure. In addition to performing such calculations after the date of transition, entities have the opportunity to restate their intangibles on transition.

Financial assets and liabilities

Dubbed ‘financial instruments’, these items will require careful scrutiny. As appropriate, there will be changes to the amounts included in the balance sheet. Where an entity holds investments, other than in subsidiaries, associates and joint ventures, these may be required to be included at fair value. Hitherto most entities have carried investments at cost, with a note to the accounts setting out the current value.

Micro-entities reporting under FRS 105 will use a simplified measurement regime for financial assets and liabilities.

Loans and financing

Entities will also need to determine the effective interest rate (EIR) for loans payable and receivable under FRS 102. Usually this will be straightforward as the commercial rate of the loan equates to the interest rate. However, where there are arrangement fees, premiums or discounts on redemption these must be considered when determining the EIR.

Where an entity has entered into a ‘financing arrangement’, typically through an interest free loan to a subsidiary or director, the present value of the loan will need to be included under FRS 102 - unless the loan is repayable on demand.

Derivatives

Financial instruments also include ‘derivatives’, which include forward exchange contracts, futures and interest rate swaps.

FRS 102 will require that these are included at the balance sheet date based on the accruals concept, rather than waiting until the end of derivative contract, or that hedge accounting is used.

Assessing the impact

A change in the recognition criteria of assets and liabilities, as well as profits and losses could have an impact on the credit rating of an entity. Additionally, where loan covenants are calculated based on profit or balance sheet measures, a move to FRS 102 could have an impact on the headroom of those covenants.

Again, clients will need to assess the impact of changes to their balance sheet and communicate to affected stakeholders.

There are opportunities on transition

Transition options

Generally on transition to FRS 102, entities are required to restate the opening comparative balance sheet (defined as the 'date of transition') to reflect the new standard. However, in some instances options are available.

Easy wins?

There is a choice within FRS 102 concerning the opening balance for property, plant and equipment. Entities are permitted to freeze the net book value at transition of a revalued asset, or revalue at transition and treat this as the "deemed cost" in the new regime. This avoids the need to revalue in subsequent years and indeed the need to pay for a revaluation.

Also, an entity which has never revalued its property, plant and equipment could do a one-off revaluation at transition and also treat this as the deemed cost. This would strengthen the balance sheet.

Assessing the impact

Transition options will need careful consideration on an individual client basis. The transitional provisions in FRS 102 run to several pages in length and options taken could have a significant effect on the financial statements. What is best for an entity may not always be the easiest choice!

Accounts will look different

Accounts formats

Fundamentally the formats of the financial statements, driven by legislative requirements, will be similar: primary statements, accounting policies and other notes to the accounts. However, there will be some subtle, yet key differences.

Terminology driven by legislation will generally be the same, however some new terms, such as 'other comprehensive income' will creep into the vocabulary direct from FRS 102. Small entities adopting FRS 102 will see simplified presentation and disclosure requirements within their full accounts and micro-entity accounts prepared using FRS 105 see further, significant simplification.

Entities will need to understand the options available and the implications that changes in accounting standards and legislation will have on accounts prepared for management, members and filing.

Operating profits and additional disclosures

Assessing operating profit is one of the most common ways of determining the performance of an entity.

The requirement to disclose operating profit on the face of the profit and loss account is currently set out in an accounting standard (FRS 3) but this is not a requirement within FRS 102. However, entities can choose to make more disclosure than the minimum requirements.

Equally entities will no longer be bound by the specific rules regarding exceptional items, such that if they wish to disclose something separately they can choose to do so.

A statement of changes in equity

FRS 102 for non-small entities requires that a 'Statement of Changes in Equity' as a primary statement is produced. This will include information about share capital, share premium, reserves and accumulated profits, together with comparative informative. Generally, this information is currently disclosed, but in the notes to the accounts. In certain circumstances this disclosure is also encouraged for small FRS102 (section 1A) adopters.

The cash flow statement

The format of a cash flow statement will differ and the definition of cash is extended to include cash and cash equivalents under FRS 102. The latter would include, for example, an investment bond which had not matured at the year-end but will do so within three months. Qualifying small companies continue to be exempt from the preparation of a cash flow statement.

Different notes disclosures

The notes to the financial statements will be different. In some areas new or additional disclosures are required, in other areas less will need to be disclosed. For example, related parties disclosures under full FRS 102 will not need to include names. Transactions and balances will still need to be disclosed, but by category of related party - such as key management, fellow subsidiaries and owners - but without names. The related party disclosure requirements for small entities see even further simplification. The differences in notes disclosures are far ranging so clients need to be aware of the need to retain comparative information.

Assessing the impact

Entities will need to gather more information for the preparation of their financial statements. Clearly this will be on an on-going basis, but also, information will be needed at the date of transition.

Entities also need to consider whether their current systems and software will be sufficient to prepare accounts under the new UK GAAP.

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