Changes in financial reporting

Seven sectors...

Originally Published: January 2016

mercia
Wilmington Finance

We're now well into 2016 and, across the nation, accountants are sharpening their pencils and brushing up on their double-entry ready for the onslaught of a new accounting regime. FRS 102 has, of course, a number of issues that impact businesses of all types - for instance, any business with a loan will need to carefully consider how to apply the dreaded financial instruments section of the new standard. However in this download, we'll summarise some of the specific issues affecting seven sectors in particular.

Retail

Sector in brief

From large high-street and out-of-town chains to smaller, independent shops, the retail sector is a key part of the UK economy. Online retail continues to prove a significant disrupter to the market across the range of goods and services we buy.

Likely impact of FRS 102	Low
Key FRS 102 issues	Operating lease incentives Employment benefits Foreign currency Revenue

Summary

Many retailers will see relatively little difference in their FRS 102 accounts. The most significant issue for profits may be the changes to the spreading of operating lease incentives, such as initial rent-free periods. Under old GAAP, such incentives were spread over the initial rent period, whereas the new standard requires such incentives to be spread over the entire lease term. This will mean lower initial profits, which will then increase in comparison to old GAAP once market rent is payable. The same is true for lessors, e.g. plant hire companies.

Retailers can employ significant numbers of staff, and accruing for short-term benefits such as annual leave (which was best practice under old GAAP) is now required. Retailers who have expanded via acquisition can sometimes find that staff are under a variety of legacy terms including differing holiday years, which can further complicate the scenario.

Retailers who import or export will be familiar with translating foreign currency transactions into sterling for their accounts. In general terms, the approach under FRS 102 mirrors that under old GAAP, but there are some notable exceptions, particularly a ban on the use of 'contract rate' translation.

Finally, revenue recognition is (for most retailers) straightforward and while this is unlikely to change under FRS 102, the inclusion of a number of practical examples covering the sale of goods in the Appendix to section 23 of the standard should provide further clarity and avoid confusion.

Manufacturing

Sector in brief

From clothing to heavy industry, manufacturing still accounts for a significant proportion of the British workforce, despite huge pressures from emerging markets.

Likely impact of FRS 102	Moderate to high
Key FRS 102 issues	Property, Plant & Equipment (PPE) Intangibles (R&D) Operating lease incentives Foreign currency Inventories Government grants

Summary

There are several potential issues for manufacturers. Firstly, whether we're talking factories or plant, there are some key differences for tangible fixed assets (now known as Property, Plant and Equipment or PPE). The useful life on such assets is no longer limited to 50 years (as was usually the case under FRS 15) but can be longer, and residual values are calculated using current, rather than historic prices. Revaluation remains an option but fair value, rather than existing use value, must be used to revalue PPE. What's more, there are important 'deemed cost' transition options in para 35.10 to consider on transition.

Manufacturers who invest heavily in R&D will be able to treat qualifying costs as assets in much the same way as under SSAP

13 (and the FRSSE), though there are minor differences between the regimes.

Like retailers, manufacturers may have entered into significant operating leases (or, in some cases, may lease equipment to customers). Incentives received or given under such leases are now spread over the entire lease term, rather than the period beyond which market rent is payable.

As for retailers, manufacturers transacting in foreign currencies (eg. for the purchase of raw materials) will generally find the approach under FRS 102 familiar, though the ‘contract rate’ method is no longer available.

Stock (or ‘inventory’) is also generally familiar under the new standard. Very few manufacturers adopted a ‘last in first out’ (LIFO) approach to valuing stock, but should note that this is now prohibited in FRS 102.

Finally, manufacturers who benefit from government grants must choose whether to continue recognising these on an accruals basis or on a ‘performance’ basis as the conditions for earning the grant have been met.

Farming

Sector in brief

In 2014, British farmers contributed over £10 billion to the UK economy. While the majority of farms are small businesses, there are some large multinationals in the sector too. Many farms also operate in ancillary sectors such as tourism and property management.

Likely impact of FRS 102	Moderate
Key FRS 102 issues	Investment properties Property, Plant & Equipment (PPE) Biological assets & agricultural produce Government grants

Summary

Farms with tenanted properties may be treating these already as investment properties, but this is even more likely to be the case under FRS 102. As such, properties must be recognised at fair value each year, although (unlike SSAP 19) if obtaining such values incur ‘undue cost or effort’ there is an option to treat at depreciated cost less impairment. This is likely to be of particular interest to farms for whom such properties are often a minor component of the business. Any revaluations will incur deferred tax.

Farm buildings and land will generally be treated as they were under FRS 15/FRSSE, under either a cost or revaluation model. The latter is a more lenient option than previously, and does not require a fixed five-year valuation cycle. Plant and equipment used in and around the farm will also generally be treated as they were under old GAAP. Note however that useful lives of assets are not limited to 50 years as was generally the case before, and this may mean more careful analysis of the life of separate components (as a much longer life may be applicable to farmhouses than outbuildings, for instance).

The biggest (potential) difference for agricultural businesses is the treatment of biological assets - living plants and animals - and agricultural produce at fair value rather than cost. It must be stressed that this is an optional treatment, and that if opted for (as opposed to using cost) this will be an irrevocable choice. Thus most farms are likely to continue cost-accounting for such assets.

To finish, government grants are similarly subject to a choice - in this case, between accruals and ‘performance’ models. Recognising grants in income when the farm has ‘performed’ its obligations is more similar to charity accounting and may have its uses.

Financial services

Sector in brief

Not just in the South East, but in several other parts of the UK, financial services employs many thousands of people and contributes hugely to the economy as a whole. Whilst the sector is dominated by global banking, investment and insurance firms, there are plenty of smaller brokers and dealers in this highly regulated industry.

Likely impact of FRS 102	Low (for most), high (for a few)
Key FRS 102 issues	Operating lease incentives Financial instruments Revenue

Summary

Like many urban businesses, financial service companies frequently lease their property and so are subject to the same lease incentive issues as retailers and manufacturers (see above).

Financial institutions which hold investments and other financial instruments will need to pay close attention to sections 11 and 12 of FRS 102 which outline recognition, measurement and disclosure. They’ll also need to refer to section 34 which outlines additional disclosures for such entities on their holdings and sources of risk. However the majority of firms, who act as brokers and/or advisers, may find that this issue affects them indirectly, if at all, so there’s no reason to panic.

Revenue recognition for services (including financial services) has been covered by UITF 40 and FRS 5 until now. Happily, the principles in section 23 are largely consistent with old GAAP and should not present too many challenges to most smaller financial services firms.

Firms which issue insurance contracts will need to look outside FRS 102 to its sister standard, FRS 103. This is a stopgap standard, consolidating the existing guidance in FRS 27 and the now-discontinued Insurance SORP, pending finalisation of IFRS 4.

Property & construction

Sector in brief

The property sector experiences both the highs and lows of the economic cycle and, while property prices have recovered strongly in recent years, construction remains weak. The sector includes large UK housebuilders as well as very small property managers and local building firms.

Likely impact of FRS 102	High
Key FRS 102 issues	Investment properties Property, Plant & Equipment (PPE)/Inventory/Revenue Borrowing costs Operating lease incentives Financial instruments

Summary

In general terms, it is the treatment of assets that has changed the most significantly under FRS 102, and the property and construction sector is all about assets being built or managed. So as you might expect, there are a number of changes for this sector.

Property managers are used to revaluing to open market value and this principle remains under FRS 102, though the term 'fair value' is substituted. From now on, however, deferred tax will be recognised on the timing differences arising when these fair value gains are brought in. The gains (and tax) will be shown in profit or loss rather than being treated as 'other comprehensive income', though they remain unrealised and therefore non-distributable.

Property which is being constructed or held for sale by developers is treated as inventory and the 'long-term contract' approach to accounting previously enshrined in SSAP 9/FRSSE is retained (albeit in the 'revenue' section of the standard). As we've noted for other sectors, there are differences for any property held for use as 'property plant & equipment' (PPE), with potentially longer useful lives and a new approach to revaluation.

Borrowing costs incurred in construction can be capitalised (as under old GAAP) or expensed as incurred, but it's worth noting that on transition, any previous borrowing costs can be left as they were.

Landlords should note that any incentives offered to tenants on property they lease will now be recognised over the entire lease term. However on transition, any existing leases' incentive treatment can be retained for ease. There are also more onerous disclosures for lessors, including details of purchase options and escalation clauses on the properties leased.

Finally, many property businesses are heavily-geared and are thus especially affected by the financial instruments changes in FRS 102.

Tourism and leisure

Sector in brief

A key and growing sector of the economy with particular importance to several of the UK's regions.

Likely impact of FRS 102	Moderate
Key FRS 102 issues	Investment properties Revenue Foreign currency Heritage assets

Summary

Holiday rental companies will treat their properties as investment properties under old GAAP and, on transition to FRS 102, will face the same issues as property firms (see above).

Revenue recognition in the leisure industry (especially holidays and travel) can prove problematic under old GAAP, with careful consideration as to whether a business is acting as principal or agent. Whilst the revenue section of FRS 102 is shorter than its equivalent in FRS 5, the principles are retained and significant changes in approach are not expected.

Firms operating overseas, or dealing with foreign tourists, will usually have experience in handling foreign currency transactions and these will largely be treated in a similar way under FRS 102.

FRS 102 will replace the existing suite of FRSs, the most recent of which (FRS 30) covered heritage assets which are of particular relevance to tourism and leisure. Whilst small entities were exempt from the standard, the eventual introduction of FRS 102 for such entities will require them to consider whether the additional requirements (in section 34) apply to them.

Transport & logistics

Sector in brief

With ever-busier infrastructure, transport and logistics comprise around 5% of GDP and include businesses of all sizes, from global courier firms to local hauliers.

Likely impact of FRS 102	Low
Key FRS 102 issues	Property, Plant & Equipment (PPE) Revenue Foreign currency

Summary

PPE includes depots and vehicles, and will in most cases be treated in the same way as under old GAAP, although attention should be paid to useful lives and residual values.

Revenue recognition for goods in transit is usually not especially challenging under old GAAP and should likewise be straightforward under FRS 102. There are several pertinent examples in the Appendix to section 23 of the standard.

For firms operating international transport, foreign currency translation will remain an issue although as noted for other sectors, in most cases the approach will be consistent with that under old GAAP.