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UK GAAP to FRS 102 illustrated

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Part 1: Changes are afoot

UK GAAP in its current form is disappearing. Its replacement consists of four standards, FRSs 100, 101, 102 and 103, which has a mandatory effective date for accounting periods beginning on or after 1 January 2015. Do you know how these changes will affect your financial statements?

FRSs 100, 101, 102 and 103 are set to replace UK GAAP in 2015, although many companies will already be contemplating early adoption of the new standards.

The change

The new standards are a step closer to IFRS and you will see a significant change in both the reporting structure of the primary financial statements and the language and terminology used.

The primary statements

An important change in FRS 102 (the key standard to be adopted) is the change in the format and titles of the primary statements:

UK GAAP	FRS 102
Profit & loss account	Income statement
Statement of total recognised gains and losses	Other comprehensive income
Balance sheet	Statement of financial position
Reconciliation of movement in shareholders' funds	Statement of changes in equity
Cash flow statement	Statement of cash flow

Companies will still have to comply with the Companies Act 2006 and some will continue to use profit and loss account and balance sheet as titles for those primary statements. So what has changed?

Key changes in accounting treatment:

Intercompany loans

A loan at an interest rate below the market rate will need to be adjusted to fair value using a market rate of interest. Any difference will most likely be recognised as a capital contribution in equity.

Loans in a subsidiary guaranteed by the parent

Bank loans issued to a subsidiary at a rate below that which would apply to a subsidiary without a parent guarantee will need to be initially measured at fair value using a market rate of interest.

Bank loan terms subject to returns other than interest rates

Under the revised version of the standard, most loans where the payments to be made are affected by anything other than interest rates or general price inflation will have to be measured at fair value, with changes in that value recognised in the income statement.

Derivatives

Derivatives will be recognised and measured at fair value. For example, a foreign currency forward contract will require separate recognition and the monetary asset or liability that it is attached to will need to be converted at the spot rate.

Profit or loss volatility

As more items are likely to be measured at fair value through the income statement, including some of the examples given above, this will increase volatility in reported results.

Impairment of financial assets

Only when there is objective evidence of an impairment will an entity be required to recognise an impairment. This will eliminate general bad debt provisions.

Intangible assets

More intangible assets will be recognised that were previously subsumed into goodwill.

Higher amortisation costs

If a reliable estimate of the useful life of goodwill or an intangible asset cannot be made, an entity must use a life not exceeding five years.

Further assistance

Moore Stephens is able to provide you with an assessment of how the new accounting standards will potentially affect your financial statements and to help you to properly prepare for the change. Please contact your local Moore Stephens adviser for more information on how we can help.

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Part 2: The statement of financial position (aka the balance sheet)

What's in a name?

The balance sheet is changing... from 2015 the document will be known as the 'statement of financial position' (SoFP) following the introduction of a new accounting standard, FRS 102. So why should you care? Well, it's not just about an accounting standard introducing new terminology, there are changes in the way certain balance sheet items are to be reported. Please read the full article for a summary of the key changes and how they will affect the way you report your financial results.

Investment property & deferred tax – Fair value movements are to be recognised within the income statement, eliminating the need for a revaluation reserve. Deferred tax is to be provided for on revaluation movements.

In the example, a deferred tax liability has been recognised on the fair value movements.

Trade debtors – A general provision for doubtful debts is no longer permitted. Only when there is objective evidence of an impairment is an impairment to be recognised. However, this may change in the future as the standard setter is considering amending this requirement before 2015.

Lease incentive prepayment – Previously, a lease incentive would have been spread over the period to when market rent will be receivable. Under FRS102, a lease incentive should be spread over the lease term, resulting in a higher prepayment released over a longer period.

Intercompany loan – If a parent company provides an intercompany loan at below market interest rates, the borrower must initially recognise the loan at fair value using a market rate of return. The reduction in the principal amount previously recognised is usually treated as a capital contribution. Interest is recognised on the loan over the borrowing period.

In the example, the difference in the fair value of the loan of £125k is recognised as a capital contribution, reducing the loan carrying value to £375k.

UK GAAP Balance sheet	£'000	FRS 102 Statement of financial position	£'000
Fixed assets		**Fixed assets**	
Tangible assets	334	Tangible assets	334
Investment property	1,115	Investment property	1,115
	1,449		1,449
Current assets		**Current assets**	
Trade debtors	42	Trade receivables	45
Lease incentive	18	Lease incentive	24
Investments	516	Investments	393
		Cash equivalents	123
Cash at bank/in hand	21	Cash at bank/in hand	21
	597		606
Creditors <1 year		**Creditors <1 year**	
Bank loan	(10)	Bank loan	(10)
Trade payables	(7)	Trade payables	(7)
	(17)		(17)
Net current assets	**580**	**Net current assets**	**589**
Bank loan	(527)	Bank loan	(543)
		Derivative	(72)
Inter-co. loan	(500)	Inter-co. loan	(375)
	(1,027)		(990)
		Provisions-deferred tax	(63)
	1,002		**985**
Capital and reserves		**Capital and reserves**	
Share capital	50	Share capital	50
Revaluation reserve	823	Capital contribution	125
Profit and loss reserve	129	Profit and loss reserve	810
	1,002		**985**

Investments and cash equivalents – Under FRS102, short-term investments that are readily convertible to cash and subject to insignificant risk should be separately identified as cash equivalents and not as investments in the SoFP or in the notes to the financial statements.

Bank loan – In some cases the loan treatment will be similar to current UK GAAP.

However, there are important differences, for example, in the treatment of loans on a change of control or to a subsidiary supported by a parent guarantee.

If the terms of the loan require a repayment on a change of control and the repayment is not linked to interest or general price inflation and principal, it should be measured at fair value through the income statement. In this example, fair value is considered to be higher than the amortised cost basis.

If a bank loan to a subsidiary is at below market rate because of the benefit of a parent guarantee, the subsidiary should measure the loan initially at fair value using a market rate of interest. The parent entity may also need to recognise the guarantee in their SoFP.

Derivatives – Previously a derivative would only have been recognised at settlement date in most cases. A derivative is now recognised as soon as it is entered into.

In the example, the interest rate swap is shown as a liability.

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Part 3: What lies beneath... The income statement

Income statement or profit and loss account?

FRS 102 is set to introduce subtle changes to the presentation of the profit and loss account. FRS 102 will introduce a choice between presenting a single 'Statement of Comprehensive Income' (SoCI) or two statements: an 'Income Statement' (similar to the current profit and loss account) and a 'SoCI' (similar to the current statement of total recognised gains and losses (STRGL)).

Key changes

In the example, we assume a two statement presentation approach is adopted by a company. We highlight some of the key changes from the current profit and loss account to the Income Statement introduced by FRS 102. 'Part 4: The Statement of Comprehensive Income' will expand on the changes from the STRGL to SoCI.

UK GAAP Profit and Loss Account	£'000	FRS 102 Income Statement	£'000
Turnover	1,115	Turnover	1,115
Cost of sales	(727)	Cost of sales	(727)
Gross profit	388	Gross profit	388
Admin expense	(129)	Admin expense	(127)
Other operating income	110	Other operating income	113
Operating profit	369	Operating profit	374
		Fair value movement on investment property and equity	68
Interest receivable and similar income	91	Interest receivable and similar income	91
		Fair value movement on derivative and bank loan	(11)
Interest payable and similar charges	(26)	Interest payable and similar charges	(50)
Profit on ordinary activities before tax	434	Profit on ordinary activities before tax	472
Taxation	(62)	Taxation	(125)
Profit on ordinary activities after tax	372	Profit on ordinary activities after tax	347

Admin expense – A general provision for doubtful debts is no longer permitted. Only when there is objective evidence of an impairment is it recognised. However, the standard board is considering changing the requirement before 2015.

Other operating income – An operating lessor (landlord) for an investment property would previously have recognised a lease incentive over the period to when market rent becomes receivable. FRS 102 requires an incentive to be spread over the whole lease term. In the example, this results in an increase in lease rental income.

Fair value movements on investment property and equity – Previously a fair value movement on investment property would have been recognised in the STRGL. FRS 102 requires such a movement to be recognised in profit or loss, increasing volatility in the Income Statement.

Previously quoted equity investments may have been recognised at cost. FRS 102 requires such investments to be measured at fair value through profit or loss.

Fair value movement on derivative and bank loan – An interest rate swap used to fix cash flows on a loan is now required to be recognised at fair value through profit or loss. Previously it would only have been recognised as cash was paid or received. Now the company will be required to recognise the change in the fair value of the derivative in profit or loss.

In the example, a bank loan fails to meet the requirements of a basic financial instrument due to a change of control. As a result, the loan is measured at fair value through profit or loss. This will increase volatility in the performance statement. The interest payable on the bank loan will continue to be recognised as interest payable.

Interest payable and similar charges – Previously interest would not have been recognised on a five year interest free loan from a parent to a subsidiary. FRS 102 will require interest to be accounted for on such a loan. This will result in an increase in interest payable as interest is added to the loan over the five year term.

Taxation – Previously deferred tax was not recognised on investment property measured at fair value. FRS 102 requires deferred tax to be recognised on the fair value movement.

A company which previously discounted deferred tax will see an increase in the deferred tax charge, as FRS 102 does not permit discounting.

Part 4: What lies beneath... The statement of comprehensive income

Is this a new statement introduced by FRS 102?

Possibly… many of the items presented in the statement of comprehensive income may be familiar but in the guise of the statement of total recognised gains and losses (STRGL), but this is dependent on the presentation format adopted by the company for the performance statement.

Key changes

The example below is a continuation from ‘Part 3: The income statement’, where a company adopts a two statement approach when presenting the performance statement. This article highlights some of the key changes from the current presentation of the STRGL to the statement of comprehensive income introduced by FRS 102.

Profit for the financial year – Some of the key differences that will arise on recognition of profit or loss for the year have been outlined in our previous update “Part 3: The income statement”.

Prior year adjustment – Prior year adjustments will now appear more frequently, however they will not be presented within the statement of comprehensive income but within the statement of changes in equity.

Prior year adjustments were previously only recognised in the STRGL for a change in accounting policy or when a fundamental error was identified in prior period financial statements. FRS 102 requires that material errors are treated as a prior year adjustment, consistent with a change in accounting policy.

UK GAAP Statement of total recognised gains and losses	£’000	FRS 102 Statement of comprehensive income	£’000
Profit for the financial year	372	Profit for the financial year	347
Unrealised surplus on revaluation of properties	51	Revaluation gain on property	32
		Deferred tax on the revaluation gain	(10)
Total recognised gains and losses relating to the year	423	Total comprehensive income for the year	369
Prior year adjustment	(25)		
Total gains and losses recognised since last annual report	398		

Revaluation gain on property – Previously the fair value movement on investment property would have been recognised in the STRGL. FRS 102 requires such movements to be recognised in profit or loss.

The remaining revaluation in this example relates to property forming part of property, plant and equipment (PPE). FRS 102 continues to allow such revaluations with gains recognised outside profit or loss.

Deferred tax on the revaluation gain – Previously deferred tax would not have been recognised on revaluation gains or losses unless there was a binding sale agreement for the asset. FRS 102 requires deferred tax to be recognised on revaluation movements, presented in the same primary statement as the underlying transaction.

FRS 102 allows items to be presented either net or gross of tax within other comprehensive income (OCI). If items within OCI are presented gross, the tax is shown in aggregate as one amount.

Total comprehensive income for the year – Where less complex transactions are undertaken by a company, few, if any, items will be recognised within OCI.

Other items that currently appear in the STRGL that will continue to be recognised include actuarial gains or losses on pensions and exchange differences on a net investment in a foreign operation in consolidated financial statements.

New items that could appear within OCI include value changes on hedged items where a company adopts cash flow hedge accounting.

Part 5: What lies beneath... The statement of changes in equity

Is this a new primary statement?

Yes… but there is a vague similarity to the old UK GAAP reconciliation of movements in shareholders' funds. Both statements provide a reconciliation of amounts available to the owners of the company but FRS 102 requires the statement of changes in equity (SOCIE) to be presented as a primary statement. It also requires a more detailed analysis of the movement in the period for each component of equity.

Some companies may decide not to present a SOCIE and instead opt to present a statement of income and retained earnings (SOIRE). This in effect combines the income statement and the SOCIE into one primary statement. Such a choice can be made when the only changes in equity are the retained profit or loss for the period, dividends, and any restatement for the prior period due to an error or change in accounting policy. If a SOIRE is presented, a retained earnings reconciliation is provided immediately following the profit or loss on ordinary activities after tax in the income statement. If there are changes in equity other than those just mentioned, for example, other comprehensive income items or a share issue in the period, a SOCIE must be used.

Key changes

In this example we highlight the key changes from the current presentation of the reconciliation of movements in shareholders' funds to the SOCIE introduced by FRS 102. The opening balances in both statements are not comparable due to changes introduced by FRS 102, as highlighted in "Part 2: The statement of financial position (aka the balance sheet)" and "Part 3: What lies beneath…The income statement".

UK GAAP
Reconciliation of movements in shareholders' funds

	£'000
Profit for the year	372
Dividends	(60)
	312
Other recognised gains and losses	51
New issue of shares	15
Addition to shareholders' funds	378
Opening shareholders' funds restated	604
Closing shareholders' funds	982

FRS 102
Statement of changes in equity

	Share capital £'000	Revaluation reserve £'000	Capital contribution £'000	Profit and loss reserve £'000	Total £'000
Balance as at the beginning of the period	35	126	125	412	698
Total effect of a prior year adjustment				(86)	(86)
Restated balance at the beginning of the period	**35**	**126**	**125**	**326**	**612**
Profit for the period				347	347
Other comprehensive income for the period		51			51
Total comprehensive income for the period		51		347	398
Proceeds from issue of shares	15				15
Dividends				(60)	(60)
Total transactions with owners recognised directly in equity	15			(60)	(45)
Balance as at the end of the period	50	177	125	613	965

Each component of equity – A reconciliation of the opening to closing position is required for each component of equity, separately identifying changes in profit or loss, other comprehensive income and those transactions that are directly recognised in equity (for example, proceeds from a share issue, dividends or capital contributions).

Total effect of a prior year adjustment – Prior year adjustments will appear more frequently as they are required for material errors and a change in accounting policy. Previously a prior year adjustment was only required for a change in accounting policy or when a fundamental error was identified in prior period financial statements.

Furthermore, a prior year adjustment applying FRS 102 is required to be presented in the SOCIE to correct the opening position. Previously the adjustment would have been presented in the statement of total recognised gains and losses.

Profit for the period – Some of the key differences that will arise on recognition of profit or loss for the year have been outlined in our previous update "Part 3: the income statement".

Other comprehensive income for the period – The analysis of other comprehensive income affecting each component of equity by item can be presented either in the SOCIE or in the notes. Therefore the level of detail presented by companies in the statement will vary.

Part 6: What lies beneath... The statement of cash flows

Cash is cash

Surely there can't be a difference between the statement of cash flows (SCF) presented in accordance with FRS 102 and old UK GAAP? That would be too easy…the SCF applying FRS 102 is more than a reconciliation of cash: it's a reconciliation of cash and cash equivalents. Cash equivalents are "short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value". This will often mean the maturity date is less than three months from the date of deposit.

Judgement will have to be applied by companies on how to classify cash flows as FRS 102 requires only three categories: operating; investing; and financing cash flows. The previous requirements were more detailed, with nine categories.

Key changes

In this example we highlight the key changes that FRS 102 will introduce in presenting the SCF.

(Table continued overleaf)

Cash flow from operating activities – Companies will generally present the reconciliation of operating cash flows on the face of the statement. Previously most companies presented the reconciliation in the notes.

Profit before tax is to be reconciled to operating cash flows (when a company adopts the indirect method). Previously, operating profit was used in the reconciliation. This will result in more reconciling items going forward.

UK GAAP Cash flow statement	£'000	£'000	FRS 102 Statement of cash flows	£'000	£'000
Cash flows from operating activities		408	Cash generated from operating activities		412
			Interest paid		(40)
			Tax paid		(112)
			Net cash flows from operating activities		260
Returns on investments and servicing of finance					
Interest paid	(40)				
Interest received	85				
Net cash flows from returns on investments and servicing of finance		45			
Taxation		(112)	Cash flows from investing activities		
Capital expenditures and financial investment			Interest received	85	
Purchase of tangible fixed assets	(178)		Purchase of tangible fixed assets	(178)	
Disposal of investment property	319		Disposal of investment property	319	
			Purchase of equity investments	(56)	
			Net cash inflow from investing activities		170

Interest paid and received, tax paid and dividend paid – A company must consistently classify cash flows between operating, investing and financing activities. For example, dividends paid can be classified within operating or financing activities. Tax paid is likely to be classified within operating activities, but if the tax relates to investing or financing activities the tax should be recognised within those categories.

Part 6: What lies beneath... The statement of cash flows (continued)

Net cash flow from management of liquid funds – This category of cash flow will more than likely fall to be either cash equivalents or investing activities applying FRS 102. In this example, the purchase of short-term bonds is considered to be cash equivalents.

UK GAAP Cash flow statement	£'000	£'000	FRS 102 Statement of cash flows	£'000	£'000
Net cash flows from capital expenditures and financial investment		141			
Equity dividends paid		(50)			
Management of liquid funds					
Purchase of equity investments	(56)				
Purchase of short-term bond	(32)				
Net cash flow from management of liquid funds		(88)	Cash flows from financing activities		
Financing			Dividends paid	(50)	
Increase in debt	480		Repayment of debt	(396)	
Repayment of debt	(396)		Increase in debt	480	
			Net cash inflows from financing activities		34
Net cash flow from financing		84	Net cash increase in cash and cash equivalents		464
Increase in cash in the period		428	Cash and cash equivalents at the beginning of the period		(337)
			Foreign exchange differences on cash and cash equivalents		(4)
			Cash and cash equivalents at the end of the period		123

Foreign exchange differences on cash or cash equivalents – Separate disclosure is required of any foreign exchange gains or losses on cash and cash equivalents as this does not form part of operating, investing or financing activities.

Cash and cash equivalents at the end of the period – A reconciliation of the opening to closing cash and cash equivalent balance is required.

Previously such a reconciliation would be combined with the reconciliation of net debt which is not required by FRS 102.

Moore Stephens UK statistics

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Fee income:	£162.4m
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