Grant Thornton

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New UK GAAP

Transition to FRS 102: what are the time critical issues?

Contents

Introduction

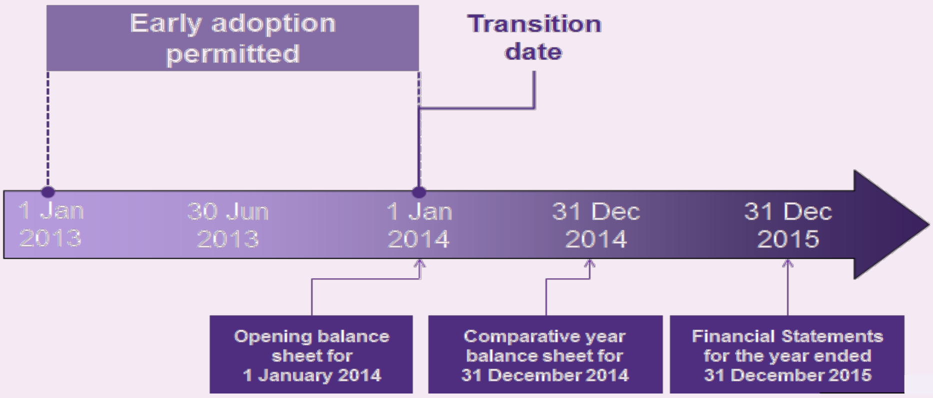
The Financial Reporting Council ("FRC") has issued the triumvirate of new standards. While the effective date for application is for accounting periods beginning on or after 1 January 2015, there are a number of areas that warrant early or immediate attention. The actual transition date is 1 January 2014 therefore, the 31 December 2013 balance sheet needs to be considered in this context given it will provide the opening position for the first FRS 102 comparatives. In this regard, management need to be informed to enable them to optimise their decision-making process and to ensure they are planning appropriately for the future.

Transition to FRS 102

What is the transition date and what do I need to consider before then?

By this stage you may be considering or indeed have already made the decision as to which GAAP your organisation will move to. In a small number of cases you may already have made the transition. However, for those who have yet to make the transition, it is useful at this juncture to pause and identify whether there are any particular areas that will be impacted that may need earlier consideration.

Recap on timeline for implementation



- this means that effectively the first balance sheet that needs to be prepared under the new standards is the balance sheet at 31 December 2013 (for transition purposes).
- FRS 102 can be early adopted for years ending on or after 31 December 2012.

What time-sensitive issues do I need to consider?

You will be aware of the three new standards and what is contained in each one at this stage. For a detailed oversight please refer to a previous Grant Thornton publication: "New UK GAAP: FRS 100 – FRS 102" issued in July 2013, which is available on our website: www.grantthornton.ie.

The purpose of this particular publication is to address those FRS 102 matters that require consideration around the transition date. The following pages outline the potential issues that may impact your company and sets out proposed actions for addressing these. Essentially, these can be broken down into two categories:

a matters requiring documentation; and

b matters requiring valuation.

Intra-group loans and guarantees

UK GAAP

Intra-group balances are recognised at the amount receivable/payable. Where there is a cross-company guarantee for the external borrowings of another group company, there are no accounting implications for the borrower where a more favourable rate may have been obtained.

FRS 102

- all inter-group balances are initially recognised at fair value, based on the timing of cash flows and the market interest rate. Measurement differences in respective debtor/creditor amounts may arise where the loan is not at market rates and repayable on demand on insistence of one party; and

- where a member of a group obtains external finance and there is a cross company guarantee in place that results in more favourable terms being obtained than might otherwise have been, then this may constitute a financing arrangement and measurement differences may therefore arise.

Implication

- for long-term intra-group loans on which interest is at off market terms, and/or where a group company obtains finance on the strength of a cross company guarantee, measurement issues may arise as the value to be recorded on initial recognition may differ from the transaction price.

- for long-term intra-group loans where interest is not charged at market terms, measurement issues arise as this is deemed to be effectively a 'gain' or capital contribution for the borrower. If higher than market terms apply, then the transaction will be recorded as a 'cost' to the subsidiary.

- where favourable terms have been obtained (from either a loan or as a result of a cross-company guarantee) this will be recorded as a 'capital contribution' in the relevant group company. Where the provider of the finance is the parent entity, the measurement differences arising will be recorded as an increase in the 'investment in subsidiary.'

- it is important to be cognisant of the fact that these same measurement implications may arise where one of the parties is a related party; for example a director providing loans at lower than market terms.

Action required

- consider whether the interest rate charged on intra-group loans represented a market rate at the inception of the loan;

- consider avoiding measurement complications by:
  a. charging a market rate of interest;
  b. giving both parties the right to demand settlement with a very short notice period; and

- any amendments need to be considered in advance of the transition date in order to avoid measurement complications. All terms should be documented before the transition date to ensure they are effective.

Potential measurement differences may arise where debtor/creditor balances in group entities are not at market terms

Tangible fixed assets

UK GAAP

Tangible fixed assets can be recorded on either an historical cost or revaluation basis in line with FRS 15.

FRS 102

- FRS 102 offers some choices upon transition. Tangible fixed assets may be measured using the historical cost model or the re-valued model as with current UK GAAP; and

- an entity can however choose at transition to revalue its tangible fixed asset (i.e. to measure at fair value) and designate the value as the deemed cost going forward without adopting an actual policy of re-valuation. A re-valuation reserve will be created for any uplift. This can be applied to any individual asset rather than a whole class if so decided.

Implication

- revaluing tangible fixed assets and designating this as the deemed cost going forward offers an opportunity for an entity to reflect current asset values in the balance sheet whilst forgoing the expense of having to perform valuations on a periodic basis.

Action required

- examine the fixed assets on an item by item and class by class basis, and ascertain whether it is beneficial and more meaningful to readers of the financial statements to revalue some or all to fair value and designate this as deemed cost going forward; and

- for re-valuations to be meaningful, they should be carried out on or around the transition date.

Re-valued amount on an asset by asset basis may be used as deemed cost going forward

Retirement benefits – group schemes

UK GAAP

The deficit or surplus on a group defined benefit scheme might only be shown in the consolidated financial statements. Also, an exemption is available which allows companies, in certain circumstances, to account for these schemes as defined contribution schemes.

FRS 102

- under FRS 102, a deficit or surplus on a group scheme must be recognised in the individual accounts of at least one group entity. By default this will be the entity that is legally responsible for the plan (this is often the parent); and

- the other group companies in their individual accounts, will account for a cost equal to their contribution for the period.

Implication

- this could have a significant impact on that companies accounts, and most notably could eliminate any distributable profits of the entity legally responsible for the scheme.

Action required

- the default treatment may be avoided where a group has a stated policy or contractual agreement for charging the net defined benefit cost to one or more individual group entities; and

- the stated policy or contractual agreement cannot be retrospectively applied. Therefore, in order to avoid recognising the full deficit for a group defined benefit scheme in the accounts of the entity legally responsible for the scheme on the transition date, the stated policy or contractual arrangement should be put in place before 1 January 2014.

Group entity legally responsible for defined benefit scheme must recognise full pension surplus/deficit, unless stated policy devised

Financial instruments – hedge accounting and derivatives

UK GAAP

Derivative contracts are not held at fair value on the balance sheet unless an election is made under the Companies Act and the full provisions of FRS 26 are applied. Presently, disclosure of any derivatives is required if they are material to enable a complete understanding of the financial statements.

FRS 102

- derivatives are normally carried at Fair Value Through Profit or Loss (FVTPL), except for in a number of limited exceptions where a reliable measure of fair value is no longer available;

- gains and losses on derivatives held as hedging instruments and meeting certain conditions are permitted to be shown in Other Comprehensive Income (OCI) and subsequently reclassified to profit or loss. It is likely that this section will be revised once the remaining IFRS 9 phases are completed; and

- for a hedging arrangement to apply from the date of transition, the hedging documentation must be in place.

Implication

- hedge accounting may only be applied from the date that the hedging documentation is in place i.e. when the entity designates and documents the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified. Therefore, failure to have the appropriate records essentially means that hedge accounting cannot be applied until such time as it is in place;

- recognition of these non-basic financial instruments and measurement thereof at FVTPL will introduce an additional element of volatility to the Profit and Loss (P&L), (should hedge accounting not be applied); and

- banking covenants may be impacted by additional volatility in the P&L.

Action required

- perform "health checks" now and work out what potential hedge relationships you may have and whether the impact of these is likely to be material. Establish whether there are any planned hedge relationships in the near future. In this way your company will be in a position when the final hedge accounting requirements come out to really think about its options;

- if your company has established that it can apply hedge accounting, ensure that you designate and document the hedging relationship on a timely basis;

- establish what, if any, derivatives your company has open at the year end. Valuations will be required at the date of transition to FRS 102, therefore the company should put in place plans to request these fair values. These valuations will need to be requested from the bank or other valuer prior to the transition date and each year end where the contract remains unsettled; and

- consider any banking covenants that may be impacted given these instruments are currently not reflected in the accounts.

Investment properties

UK GAAP

Investment properties are not depreciated and are included on the balance sheet at their open market value. Under current UK GAAP, property let to another group company is explicitly excluded from classification as investment property in either the company's own accounts or the group accounts.

FRS 102

- investment property is to be measured at fair value at each period end, with any movement recorded in profit or loss. Deferred tax will need to be recognised on the fair value movements;
- the profit on revaluation of investment property will not be a realised profit for distribution; and
- no similar exception for property let within a group exists, therefore premises rented to other group entities are to be measured at FVTPL. On consolidation, the premises will be reclassified to property, plant and equipment.

Implication

- measurement at FVTPL will introduce an additional level of volatility to the P&L;
- deferred tax will have to be measured on any fair value movements; and
- fair value will have to be estimated at each year end.

Action required

- determine if any properties will now have to be classified as investment properties and organise valuations to take place to reflect the 1 January 2014 fair value.

Properties utilised within a group may meet the definition of an investment property under FRS 102. They are not explicitly excluded from classification as such as was previously the case.

Other issues to consider

There are a number of other areas that should ideally be considered around the transition date but that are not as time-critical. These include:

Loan terms and related covenants

When loans are being negotiated, it is important to consider the impact that different valuation requirements under FRS 102 will have on various figures, for example, now that forward contracts will be recognised at fair value, this could affect the balance sheet figures used to calculate the current ratio.

Compensated absences

Under FRS 102, there will be a requirement to accrue for compensated absences. If an entity compensates employees for absence for various reasons, including annual leave and sick leave, and if these accumulate and carry forward if not used, then an entity shall recognise the expected cost of accumulating compensated absences when the employees render services that increase their entitlement to future compensated absences.

Companies should therefore consider whether their existing HR systems are capable of capturing this required information and if not, put in the appropriate systems and/or processes from the transition date.

Corporation tax

The effect of FRS 102 on corporation tax in Ireland and Northern Ireland is not yet clear but it is likely that there will be some issues to be considered and potentially some beneficial elections available. Grant Thornton is actively engaged in monitoring this situation and will circulate details on the adopted tax position by the relevant taxation authorities once the transition rules have been clarified.

We will issue further information once the situation becomes clearer over the coming months.

Contacts

This factsheet can serve only as an introduction to the time-sensitive issues raised by the FRC's fundamental changes to UK GAAP. The impact of these changes will vary from entity to entity.

If you wish to learn more on the various other topics that are impacted by the transition to FRS 102, please visit our website at **www.grantthorntonni.com**, or alternatively to discuss the specific circumstances of your company, please contact your usual Grant Thornton representative or any of the following:

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