TACKLING THE FRS 102 IMPLEMENTATION 'IMPs'

The devil is always in the detail and those engaged in FRS 102 transition projects will know that there are several accounting 'imps' to tackle. **Oliver Holt** and **Ciarán O'Brien** review some of the more problematic areas.

This article describes some of the areas where implementing FRS 102 can give rise to difficulties. Space does not permit us to cover all the challenges that may be encountered but the following may prove to be a useful guide.

IMP #1: COST

Due to the summarised nature of financial statements, the impact of the implementation of FRS 102 may well not be apparent to shareholders and other stakeholders. Astute finance directors recognise this and will prepare to explain the areas of change even though stakeholders may not appreciate the difficulties encountered.

Furthermore, while compliance with FRS 102 may add cost to the preparation of the financial statements it will not have a particularly material impact on the views expressed. Changes in the language used for headings or titles under FRS 102 fall into this category along with some of the additional disclosures required. For example, there is a requirement to present an analysis of expenses by nature (such as light and heat; rent and rates) where the profit and loss accounts present expenses by function (cost of sales; selling and distributions; administration costs). Professional analysts find expenses by nature useful information for their EPS forecasting models but relatively few of the financial statements produced under FRS 102 will have any following in the investor analysis community.

In the same vein, FRS 102 might offer a more complex route to the same accounting answer – but navigating that route can be fraught with difficulty as illustrated by our next imp, borrowings.

IMP #2: BORROWINGS

Previously in *Accountancy Ireland*, the impact of a repay on demand feature within a loan contract was highlighted.[1]

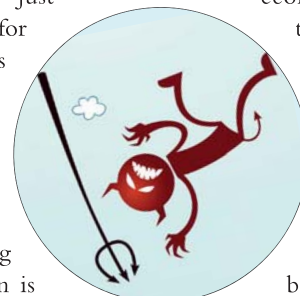
There is potential to leave the accounting more or less as is for the parties to a loan where FRS 102's recognition and measurement rules in sections 11 *Basic financial instruments* and 12 *Other financial instruments* issues are adopted. The other accounting implications of an on demand feature, however, may not appeal, especially where the loan is for a significant amount; for example, the loan will be presented in both parties' financial statements as current. This could present balance sheet strength issues for many entities where such borrowings are presented as due within one year or less.

This little imp has the potential to be pretty harmful since the accounting applies to all business loans and not just intercompany loans. The accounting for any loan with off market terms such as shareholders' loans, directors' loans or employee loans are all potentially impacted.

For calendar year reporters, the date of transition to FRS 102 was 1 January 2015. So, if there is an existing off-market borrowing, the question is whether the on demand feature is already in the implied terms of the contract.

Loan documentation may not be that extensive. Often, there is no commercial imperative for detailed documentation. Typically, for example, in an intercompany loan scenario each of the parties is under common control so there is no apparent requirement to incur the cost of recording what is understood already by each party and can be enforced within the group. It may therefore be the case that the on demand feature needs to be put formally in place. Where this reflects the terms and conditions understood by the parties at inception of the loan (for example, where the amounts have always been shown as current in the financial statements), insertion of the on demand feature might not appear to be an issue.

However, lender entities showing an on-demand loan as an asset, will need to consider the recoverability of the loan and its presentation as a current asset. Section 5(f) Companies (Amendment) Act 1986 (Companies Act 2014: para 17 to Schedule 3) requires the directors to have regard to economic substance when presenting amounts in the financial statements. Accordingly, where an on-demand feature exists but there is no evidence that it is economically feasible for the loan to be successfully repaid within one year, the lending entity directors will be required to consider the impact on the presentation to be adopted.



IMP #3: FINANCIAL INSTRUMENTS

The term, 'financial instrument' has a broad definition in FRS 102 covering any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another. This covers a multitude including all debtors and creditors. FRS 102 adopters have an accounting policy choice to make when deciding how to recognise and measure their financial instruments between:

- Sections 11 and 12 of FRS 102;
- IAS 39;
- IFRS 9 and/or IAS 39 (as amended following the publication of IFRS 9).

Without a detailed understanding of the current and immediately contemplated financial instruments of a reporting entity it is difficult to determine the appropriate accounting choice. A change in policy is, of course, possible at some future stage if that change provides more reliable and relevant information about the effects of transactions and other events or conditions on an entity's financial position, financial performance or cash flows. Given the concentration of resources needed to transition to the new regime, however, it may appear wasteful not to choose a future-proofed accounting policy for the recognition and measurement of financial instruments.

In all but the most straightforward of cases, the effort required to determine the most appropriate choice is not trivial and caution needs to be taken to ensure that the transition project does not simply default to adopting sections 11 and 12 without consideration of the accounting benefits available from the other two choices – IAS 39, IFRS 9 and/or IAS 39 (as amended following the publication of IFRS 9). For example, for some reporters, the new fair value through OCI category in IFRS 9 may be attractive.

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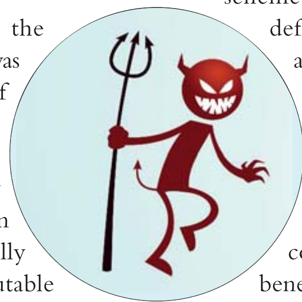
IMP #4: FAIR VALUES

Under FRS 102, some reporting entities will report certain items under fair value for the first time with consequent volatility in the profit and loss account on both a before and after tax basis. Examples include (but are not limited to) certain equity investments, derivatives such as interest rate swaps, forward foreign exchange and commodities contracts, and investment properties. To some extent, the ability to use hedge accounting may alleviate this issue.

IMP #5: DISTRIBUTABLE RESERVES

For many reporting entities, the profit and loss account reserve was traditionally a good indicator of the likely quantum of the company's distributable reserves. Some, but relatively little, adjustment may have been required to calculate the legally available accumulated distributable reserves. FRS 102 changes this for many entities. For example, the inclusion of fair value adjustments into the profit and loss account under FRS 102 may require more extensive calculation to gauge the level of distributable reserves. For many entities, this calculation will not be straightforward. You might expect that mark-to-market gains on a bond or a stock required to be brought to the profit or loss account under FRS 102 could be regarded as distributable, but is this the wise course of action? Matters to consider include whether the market for the particular investment is volatile (i.e. over a short time the profit may be replaced by losses) or whether the investment cannot be readily realised without impacting the business (for example, where a stake is strategic and there is no intention to sell).

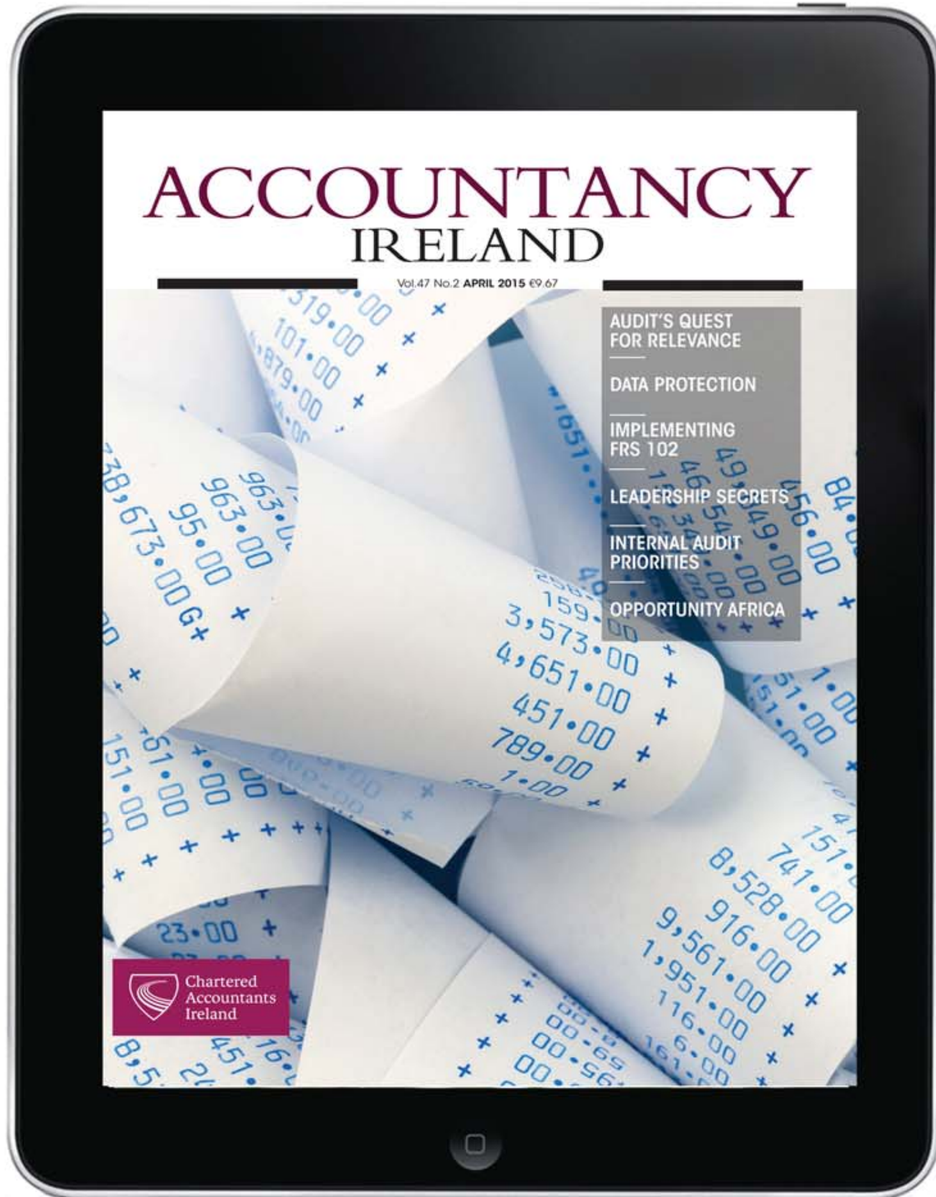


Each line item in the profit and loss may require particular consideration in terms of the impact it could have on accumulated reserves as the next imp, pensions, illustrates.

IMP #6: PENSIONS

Companies with a defined benefit pension plan are likely to report increased pension charges in their financial statements under FRS 102 thanks to the requirement to report "net interest cost". Previously under FRS 17 *Retirement Benefits* the expected rate of return on assets was usually assumed to have been somewhat higher than the discount rate based on the return from AA corporate bonds. FRS 102, like IAS 19R, only allows the reporter to take a return on pension scheme assets to the profit and loss account based on the discount rate.

Under FRS 17 it was possible in certain circumstances for employers within a group scheme to offer their employees a defined benefit pension but to account for the employers' contribution as if the scheme were a defined contribution scheme. Instead under FRS 17 the group's pension scheme was accounted for at consolidated level as a defined benefit scheme.



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Under FRS 102, if they are legally responsible for the plan, the employer may find that the entire defined benefit liability will appear in their financial statements at an entity level thus impacting reserves available for distribution. Helpfully, under FRS 102, defined benefit pension scheme costs and liabilities can be shared across the group where there is a contractual agreement or stated policy for sharing.

The impact on distributable reserves may cause difficulties but there are some potential work-arounds; for example, with the agreement of plan trustees, it may be possible to change the employer with lead responsibility for the pension arrangement within the group. It might also be possible to establish within the group a new corporate entity that employs all personnel and charges them out to the rest of the group. Personnel and operational difficulties in successfully implementing such changes should be carefully considered, however, since executing a change in employer, even if only nominally, is not a small task.

IMP #7: TAXATION

Accounting for taxation mostly follows the principles previously applied under FRS 16 *Current Tax* and FRS 19 *Deferred Tax*. However, under FRS 102 section 29 Income Tax, the provision for deferred tax is extended to include the taxation consequences of certain valuation differences.

A revaluation of a fixed asset is taken to reserves so the deferred tax consequence will also be dealt with in reserves. If the fixed asset being revalued is non-depreciable (eg land) the deferred tax is measured at the capital gains tax rate. The revaluation of an investment property that is marked to market will impact on the profit and loss account – and so too will the deferred (capital gains) tax on the related capital gain.

On acquisition, business combination accounting requires that any fair value changes in recognising acquired assets and liabilities are reflected in goodwill. The deferred tax arising on fair value adjustments will also impact on goodwill. In calculating the deferred tax consequence, the standard refers to "the amount that can be deducted for tax for an asset". In the case of, say, plant and machinery this amount will be the unused capital allowances in the subsidiary's corporation tax computation. In the case of an intangible asset recognised for the first time on acquisition, the amount that can be deducted for tax in the subsidiary will be nil.

As a result, more deferred tax is likely to be recognised under FRS 102 in acquisition situations.

IMP #8: REDUCED DISCLOSURES

Section 1 of FRS 102 sets out reduced disclosure for "qualifying entities". There are some conditions to be met: for example, the entity's accounts must be consolidated into a set of accounts intended to give a true and fair view and where these consolidated accounts may be obtained must be disclosed, along with a brief narrative explaining the disclosure reduction.

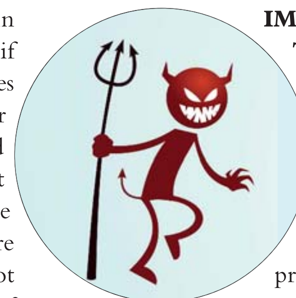
Reduced disclosures can be attractive, especially when it is desired to save the effort involved in the preparation and presentation of a cash flow statement. However, the reductions are never available in consolidated financial statements, even if voluntarily prepared. Furthermore, associates and joint ventures (unless they have other shareholders with a controlling interest and meet the other conditions) are not qualifying entities and therefore are excluded from the reduced disclosure regime. Subsidiaries whose parents do not consolidate them (on grounds of immateriality or because the group meets the size exemption) also do not meet the reduced disclosure requirements.

For an entity to take the disclosure reductions in its entity-only financial statements it must have notified its shareholders in writing. If objections are received from shareholders with more than 5% of the allotted shares (or more than half of the shares not held by the immediate parent) then the reduced disclosures are not available. Where it is known that minority shareholders rely on the information in the annual statutory financial statements, often management may consider foregoing the disclosure reductions to better meet the information needs of some of the stakeholders.

IMP #9 GOODWILL & INTANGIBLES

Under FRS 102, intangible fixed assets are not permitted to have indefinite useful lives. On transition therefore, the lives of such intangibles require re-assessment and are amortised prospectively from the transition date. Where no reliable estimate of useful life can be made FRS 102 presumes a life of less than five years. However, this is unlikely to be the appropriate response for intangibles previously identified as having an indefinite life. To complicate matters further, for periods beginning on or after 1 January 2016, EU company law suggests a maximum life of five to ten years (article 12(11) Directive 2013/34/EU). Given the new requirements, careful consideration of the basis for a reliable estimate of useful life is required.

IMP #10 TRANSITION OPTIONS



Section 35 of FRS 102 offers more than 18 options to make the transition process less cumbersome and costly. The number of options is an issue in itself and time is needed to identify which are best – something that can only be done on a case by case basis. ■

[1] Holt, Oliver "Dramatic Changes in accounting for intercompany loans", *Accountancy Ireland,* Vol 46, No 4, August 2014.)

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