FRS 101 and 102: a New GAAP with Old Problems?

Michael Raine *Director, Tax Accounting Team, Deloitte*
Shane Murphy *Senior Manager, Tax Accounting Team, Deloitte*

Introduction

Broadly, for accounting periods commencing on or after 1 January 2015, companies must now prepare their statutory financial statements under FRS 101, FRS 102 or IFRS. The question that commonly arises is whether transitioning to FRS 101, FRS 102 or IFRS results in more or less tax being payable. The purpose of this article is to address this question and also to highlight other tax areas relevant to the transition.

Overview of Accounting Frameworks Available

In the past most Irish companies prepared their statutory/individual financial statements using Irish GAAP (generally accepted accounting principles), referred to hereafter as "old Irish GAAP". A small number of companies prepared their statutory/individual financial statements using IFRS (International Financial Reporting Standards). In addition, Irish companies had the option of preparing financial statements for periods ending on or after 31 December 2012 using FRS (Financial Reporting Standard) 101 or FRS 102.

For all accounting periods beginning after 1 January 2015, old Irish GAAP is no longer an option, and most Irish companies must choose to prepare their financial statements under IFRS, FRS 101 or FRS 102. It is likely that the majority of Irish companies currently preparing their financial statements using old Irish GAAP will choose to transition to FRS 102 ("new Irish GAAP").

Transitioning from old Irish GAAP to IFRS, FRS 101 or FRS 102 may result in different treatment of particular items in the financial statements and thus impact on the numbers. For example, a company preparing its financial statements under old Irish GAAP may get a profit of X, but using the same facts, if the company prepared its financial statements under new Irish GAAP, it may get a profit of Y. In addition, the various accounting standards have different disclosure requirements: for example, although the accounting treatment under FRS 101 is broadly the same as IFRS, there are fewer disclosure requirements under FRS 101.

You should note that Irish companies with securities listed on certain regulated markets within the EU (such as the Irish Stock Exchange's main securities market) are required by law to prepare their consolidated financial statements using EU-adopted IFRS, and this will remain the case going forward. An Irish plc may, however, prepare the individual statutory financial statements of the companies within the group under IFRS, FRS 101 or FRS 102, i.e. although the consolidated financial statements generally need to be prepared using IFRS, the individual statutory financial statements of the parent or subsidiary companies need not be prepared under IFRS. Note that in preparing the individual statutory parent or subsidiary financial statements, the directors are obliged to apply a consistent accounting framework throughout the group unless there are good reasons to do otherwise.

Overview of Taxation on Transition

Broadly, the corporation tax implications of changing accounting framework, whether it be to IFRS, FRS 101 or FRS102, are threefold:

› the tax impact on transition,

› the ongoing cash tax implications and

› the tax accounting implications.

Tax impact on transition

On transition, both income and expenses may drop out of the tax net or be double-counted. Schedule 17A TCA 1997, which is given effect by s76A(2) TCA 1997, operates to ensure that these amounts are not double-counted or excluded from the tax net.

Schedule 17A was introduced by Finance Act 2005 to deal with companies moving from Irish GAAP to IFRS. Finance Act 2014 amended Schedule 17A to ensure that covered both FRS 101 and FRS 102 from 1 January 2015. Revenue has confirmed in its guidance that it will follow Schedule 17A for accounting periods ending before that date for "early adopters" of FRS 101 and FRS 102.

Ongoing cash tax implications

In terms of taxation, the importance of accounting is that it will determine **when** income and expenditure are brought into the tax net. Section 76A TCA 1997 states that

> *"for the purposes of Case I…the profits…of a trade…carried on by a company shall be computed in accordance with generally accepted accounting practice subject to any adjustment required…by law".*

It is outside the scope of this article to discuss the meaning of s76A, but in the authors' view s76A determines the timing of income and expense recognition and nothing more. For further reading in this area, we would direct the reader to Chapter 2 of *Taxing GAAP and IFRS* by Tom Maguire.[1]

It is important for companies to consider the ongoing tax impact of transition as, although ultimately it should not result in more or less cash tax being payable, it could impact on the timing of when tax is payable and thus cash-flow.

Tax Accounting

Current tax may arise on the transitional adjustment. In addition, consideration will need to be given to whether deferred tax should be recognised on the underlying transaction itself. It should be noted that under IFRS, FRS 101 and FRS 102 more deferred tax balances are likely to arise than previously under old Irish GAAP, e.g. deferred tax on business combinations and revaluations.

Specific Examples

We set out below a number of practical transition examples. The reader should note that this is not an exhaustive list of such examples.

1 Tom Maguire, *Taxing GAAP and IFRS* (Dublin: Irish Tax Institute, 2006).

Example 1: Development costs

A company prepared its financial statements under old Irish GAAP until 31 December 2014 and expensed all development costs under old Irish GAAP. For the year ended 31 December 2015, the company prepared its financial statements under FRS 101, whereby all development costs are capitalised and subsequently amortised to the profit or loss account (P/L).

In 2014, under old Irish GAAP, development costs of 100 were charged to the P&L and a tax deduction was taken in full for that amount. Assuming no other expenditure in prior years, under FRS 101, this expenditure is capitalised and written off to the P&L over five years.

Accounting

Under FRS 101, the opening balance will be restated so that the balance at 1 January 2015 will be 80, i.e. the cost of 100 less the amount amortised in 2014 of 20.

The amount amortised to the P&L in each of the years 2015, 2016, 2017 and 2018 will be 20.

Cash tax impact

As mentioned, the accounting will determine ***when*** *amounts of expenditure are deductible, but the question of* ***whether*** *such amounts are deductible has to be decided from the application of law, e.g. whether they were incurred wholly and exclusively for the purposes of the trade etc. As amortisation of 20 is charged to the P&L in 2015, 2016, 2017 and 2018, a tax deduction should be taken in each of these years for that amount on the basis of meeting the tests in law.*

Transitional adjustment

By way of background, if the adjustment is in relation to neither bad debts nor financial instruments, it is likely to be dealt with by Schedule 17A(2). The purpose of this paragraph is to take amounts receivable or deductible that could be double-counted or fall out of tax by virtue of the move to the new accounting framework and either to tax or to allow a deduction for the resultant income or expenditure over a five-year period. It should be noted that the adjustment must be spread over five ***years****. For example, it is not possible to accelerate a deduction by preparing five short accounting periods. In addition, should the company cease trading within the five-year period, a form of "catch-up" adjustment is performed.*

To arrive at the transitional adjustment, the difference between the "taxable amount" and the "deductible amount" (both of which are defined in para. 2 Schedule 17A) needs to be ascertained

Deductible amount

A deductible amount is either:

- *an amount receivable by the company that falls to be taken into account as a trading receipt for Case I or II under FRS 101/102/IFRS and that was also taken into account as a trading receipt in an earlier accounting period, i.e. where an amount of income is taxed twice, once under Irish GAAP and once under FRS 101/102/IFRS; or*
- *an expense that falls out of deduction for taxation on the transition from Irish GAAP to FRS 101/102/IFRS.*

Taxable amount

A taxable amount is either:

- *an amount receivable by a company that would have been taken into account as a trading receipt in financial statements prepared under FRS 101/102/IFRS but that is not included in an FRS 101/102/IFRS accounting period or a prior accounting period, i.e. an income amount that falls out of the charge to tax on the transition from Irish GAAP to FRS 101/102/IFRS; or*
- *an expense that falls to be deductible under FRS 101/102/IFRS for which a deduction has already been taken in an earlier accounting period, i.e. an expense that is charged to the P&L before and after the adoption of FRS 101/102/IFRS.*

Where the taxable amount exceeds the deductible amount, the excess is to be regarded as a trading receipt. Where the deductible amount exceeds the taxable amount, the excess is to be regarded as a deductible expense. In both instances, the taxable or deductible amount must be spread over five years beginning with the first accounting period in which the profits or gains are charged to tax in accordance with FRS 101/102/IFRS.

To return to our example:

- *A deduction was taken in 2014 for 100.*
- *A deduction will be taken in 2015, 2016, 2017 and 2018 for 20 in each year, i.e. 80 in total.*
- *Thus, without transitional measures, the company could get a deduction for 180 while incurring only 100.*

- *Schedule 17A kicks in so that the 80 (180 – 100) is treated as a "taxable amount" and spread over five years, i.e. it is effectively taxable income of 16 in each of the years 2015–18.*
- *The net effect is that the company gets a tax deduction for 100.*

Tax accounting

The opening tax position at 1 January 2015 will need to be adjusted to reflect a current tax liability of 10 (80 at 12.5%) in respect of the transitional adjustment.

Borrowing costs

Provided that borrowing costs are fully deductible, the analysis would be broadly the same as for the above development expenditure analysis.

Example 2: Financial instruments

A financial instrument cost 100 in 2013. It had a fair value of 130 at 31 December 2014. The company began preparing its financial statements under FRS 101 in the year ended 31 December 2015. A fair-value gain of 20 was recognised in the year ended 31 December 2016, bringing the carrying value of the financial instrument to 150. The financial instrument was sold for 150 in 2020.

For the purposes of this example, we have assumed that the financial instrument is a trading asset and it was not fair valued when prepared under old Irish GAAP.

Accounting

The opening reserves at 1 January 2015 will be increased by 30 to reflect the unrealised profit on the financial instrument up to 31 December 2014. An unrealised profit of 20 is booked to the P&L in 2016.

Cash tax

As mentioned, s76A TCA 1997 states that "profits…shall be computed in accordance with generally accepted accounting practice subject to any adjustment required…by law". Thus, in terms of the timing of income and expense recognition, the taxation or deduction of same will follow the accounts "subject to any adjustment required…by law". In the authors' view, the adjustment referred to would include the rule that neither profit nor loss may be anticipated, i.e. under general Irish tax principles, as a result of such cases as A B Ltd v MacGiolla Riogh (Inspector of Taxes) [1960]*, the strict rule of law is that profits are subject to tax only on a realised basis. Unrealised gains or losses should not be taxable or deductible, until such time as they are realised.*

Section 76B(2) TCA 1997 overrides this general principle of tax law in certain instances, stating that:

> *"a profit or gain from a financial asset or a financial liability of a company that, in accordance with relevant accounting standards,…is –*
>
> *(a) calculated on the basis of fair values of the asset or the liability in an accounting period, and*
>
> *(b) included in the profit or loss of the company for the accounting period,*
>
> *shall be taken into account on that basis in computing profits or gains of the company…".*

Effectively, this means that fair-value movements on financial assets/liabilities (as defined by the accounting standards) are taxable/deductible in line with the accounting treatment, provided that the financial statements are prepared using FRS 101, FRS 102 or IFRS and the fair-value movements are booked in the P&L/ income statement.

To return to our example, under general principles the fair-value movement of 20 in 2016 would not be taxable as it is unrealised. However, s76B may override this general principle, the effect being that the 20 is taxed in line with the financial statements, i.e. the 20 is taxed in 2016.

When the actual gain of 50 is realised in 2020, this is effectively ignored for tax purposes as it has already been taxed in line with the financial statements, i.e. the transitional adjustment of 30 (see below) together with the 2016 fair-value movement of 20.

Transitional adjustment

The relief given for gains or losses on financial assets or liabilities on the transition to FRS 101/102/IFRS is very similar to that given for non-specific items such as development expenditure (Example 1). Paragraph 4 of Schedule 17A deals with transitional arrangements in connection with financial instruments.

There are a number of relevant definitions, as follows.

Changeover day

The changeover day broadly means the last day of the accounting period immediately preceding the first accounting period of the company in respect of which profits for the purposes of Case I or II of Schedule D are computed in accordance with FRS 101/102/IFRS.

Deductible amount

A deductible amount includes so much of any amount of loss accruing on or before the changeover day on a financial asset or a financial liability of a company that had not been realised before that day and that would have been deductible after the changeover day but the accounting treatment denies such a deduction, i.e. an unrealised loss on a financial instrument on transition, where such unrealised loss has not been taken into account as a deduction before the changeover day.

Taxable amount

A taxable amount includes any amount of profits or gains accruing on or before the changeover day on a financial asset or financial liability of the company, being profits or gains that had not been realised on or before that day and that would have been taken into account in computing the profits or gains of the company for the purposes of Case I or II of Schedule D if they had accrued in an accounting period commencing after the changeover day, as apart from this paragraph, would not be so taken into account for any accounting period of the company (i.e. an unrealised gain on a financial instrument, where such unrealised gain has not been taxed before the changeover day).

Similar to the transitional arrangements for non-specific items (Example 1), the transitional adjustment arising on financial instruments on the transition to FRS 101/102/IFRS is taxable or deductible, as the case may be, over five years.

To return to our example, before the transition to FRS 101, the company booked the financial instrument at cost, and no fair-value movements were charged to the P&L. As nothing was charged to the P&L, the unrealised gain of 30 is ignored for taxation purposes.

On transition, however, the 30 that would otherwise have fallen out of the system is identified as a taxable amount. This will be subject to tax over five years (i.e. 6 in each year), on the assumption that the company does not cease to trade in that period.

Tax accounting

The opening balance at 1 January 2015 will need to be adjusted to reflect current tax on the transitional adjustment. This will result in a current tax liability of 3.75 (30 at 12.5%). The resulting debit will be to reserves.

The transitional adjustment of 30 will be taxed over five years, and accordingly the current tax liability will be unwound to the P&L over five years as follows:

	Dr/(Cr) in P&L
2015	(0.75)
2016	(0.75)
2017	(0.75)
2018	(0.75)
2019	(0.75)

No deferred tax asset/liability arises in 2016 as a result of the fair-value movement of 20, as the taxation follows the accounting.

Example 3: Bad debts

"General bad-debt provision" at 31 December 2014 under old Irish GAAP	100
"Specific bad-debt provision" at 31 December 2014 under old Irish GAAP	200
Debtors impaired at 1 January 2015 under FRS 102 ("opening bad-debt provision")	300
Debtors impaired at 31 December 2015 under FRS 102 ("current bad-debt provision")	150

Cash tax impact

The reduction of 150 in the impairment in 2015 is taxable in line with the financial statements.

Transitional adjustment

General bad-debt provision

After transition to FRS 101/102/IFRS, it will not be possible to recognise a general bad-debt provision. On transition, the opening balance will need to be adjusted to remove any general bad-debt provision.

As no tax deduction should have been taken on recognition of the general bad-debt provision, there should be no tax impact on de-recognition of the general bad-debt provision.

Specific bad-debt provision

Under FRS 101/102/IFRS, there is no longer a concept of bad-debt provision, but instead an allowance is made for debtors that are estimated to be impaired on the basis of the objective evidence available.

To determine the adjustment for tax purposes, the following comparison needs to be made on a year-in/year-out basis until such time as the transitional adjustment for bad debts has been recovered:

The opening bad-debt provision is compared with the ***higher of****:*

- *the current bad-debt provision or*
- *the specific bad-debt provision.*

Where the opening bad-debt provision does not exceed the higher of the current bad-debt provision or the specific bad-debt provision, no relief will be available.

Where the opening bad-debt provision exceeds the higher of the current bad-debt provision or the specific bad-debt provision, a deduction will be available. The timing of the deduction is not the five-year spread, discussed earlier, but a full deduction is given in the year in which the opening bad debt provision exceeds the higher of the current or specific bad debt provision.

To return to the example:

- *Opening bad-debt provision* *300*

Compared with the ***higher of****:*

- *Current bad-debt provision* *150*
- *Specific bad-debt provision* *200*

The excess 100 (300 – 200) is deductible in 2015.

Tax Accounting

Any deferred tax on the general provision will need to be reversed. The 2015 opening balances will need to be adjusted to reflect the current tax on the above changes to the specific provision. A tax asset of 12.5 should be recognised (300 – 200 = 100 at 12.5%).

Example 4: Investment properties

A company begins preparing its financial statements under FRS 101 in the year ended 31 December 2015 and chooses to fair-value an investment property through the P&L. For tax purposes, the investment property is not a trading asset, and it is therefore subject to CGT.

The investment property cost €1m in 2012. It had a fair value of €1.3m at 31 December 2014. A fair-value gain of €100k was recognised in the P&L in the year ended 31 December 2015, bringing the carrying value of the investment property to €1.4m.

Transitional adjustment/cash tax impact

There are no transitional adjustments or cash tax impact. The investment property is subject to CGT. Because unrealised gains can be ignored for CGT purposes, tax will arise on the actual disposal of the investment property.

Tax accounting

A DTL will arise on the revaluation. For example, the opening balance at 1 January 2015 should reflect a DTL of €99k (€300k at 33%). The resulting debit should be to reserves.

In 2015 the DTL should be increased by €33k, i.e.

Dr	Tax P&L	€33k
Cr	DTL	€33k

Conclusion

Although the transition to the new standards is primarily an accounting issue, there are many different aspects to consider, including tax. It is important that tax practitioners consider the impact of the transition and understand the accounting associated with it. Given time pressures at year-end, practitioners should endeavour to consider this beforehand.

Read more on taxfind Accouting Aspects, *Irish Tax Review*, Issue 2, 2015