KPMG
cutting through complexity

A quick guide to K3

New standard for financial reporting

kpmg.se/k2k3

Income tax
Consolidated accounts
Provisions
Capitalise
Generally accepted accounting principles
K3
Swedish Accounting Standards Board
Subsidiary
Share-based payment
Minority interest
Limited company
Non-current asset
Component
Deferred tax
Annual report
Larger companies
Group contribution
Work in progress
Useful life
Calendar year
Transition
Pension plans
Category
Accounting
Financial instruments
Impairment
Disclosure
Legal entity
Administration report
Investment property disclosures
Subsidiary
Full goodwill method
Provisions
Lease contract
Foundation
Fair value
Transition
Group contribution

K3 new standard for financial reporting

What does the new accounting regulation K3 mean? How does it differ from current standards and how will it affect you and your organisation? KPMG's specialists Catharina Pramhäll and Caisa Drefeldt explain the concepts.

K3 is the new primary standard for all larger entities in Sweden. It applies to financial years that begin after 31 December 2013, which for entities using the calendar year as the financial year means from 2014, but it may be applied earlier.

Who is affected by K3?

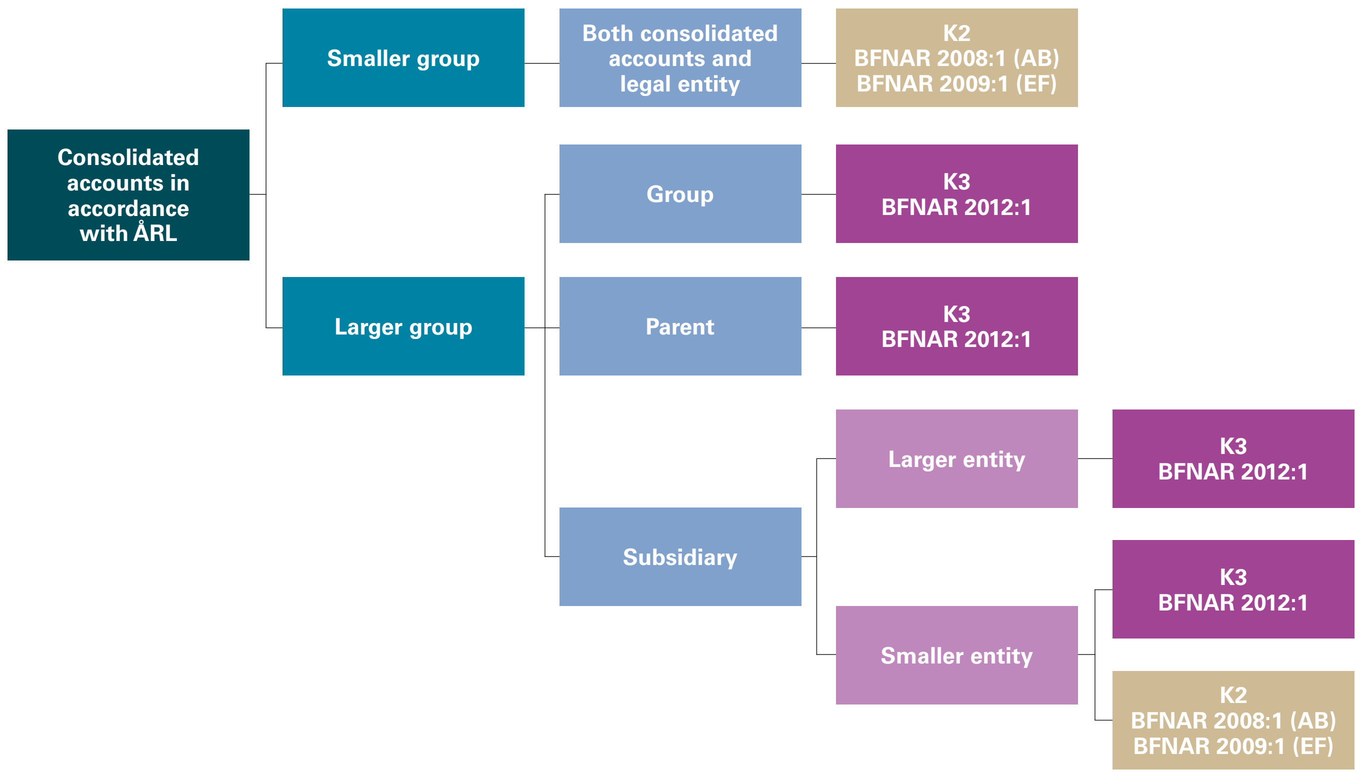
K3 is mandatory for all entities which are classified as larger in accordance with Årsredovisningslagen (ÅRL; Annual Accounts Act). That is entities with:

- More than 50 employees on average
- More than SEK 40 million in balance sheet total
- More than SEK 80 million in sales

When the same two of these criteria have been met for two consecutive years, the entity is classified as larger in the third year.

Smaller limited entities and cooperative associations may choose the simplified standard K2, either Bokföringsnämnden's (Swedish Accounting Standards Board) standard for annual reports in smaller limited companies (BFNAR 2008:1) or Bokföringsnämnden's standard for annual reports in smaller cooperative associations (BFNAR 2009:1). K2 is not yet finished for some forms of association, for example partnerships (handelsbolag) and foundations. In the meantime these forms of association continue to use the old standards from Bokföringsnämnden or RR 1-RR 29 from Redovisningsrådet (Swedish Financial Accounting Standards Council).

The following figure illustrates which accounting regulation(s) different entities need to apply.



A parent applying IFRS in its consolidated accounts is not allowed to use K3; instead RFR 2 should be applied in the legal entity. This is, however, not the case for subsidiaries in IFRS groups. They may choose to apply RFR 2 or K3 or K2, depending on size.

Since K3 is applicable for entities that apply ÅRL, entities that apply ÅRKL (Annual Reports Act for Credit Institutions and Securities Companies) and ÅRFL (Annual Reports Act for Insurance Undertakings) are not allowed to apply K3.

Date of transition

The main principle for transition to K3 is that entities should restate the financial statements for one comparative year. The date of transition is therefore 1 January 2013 for entities that have the calendar year as the financial year. It is therefore essential to analyse the consequences the transition will have, prepare to adapt, and identify which items need to be restated.

What are the differences between K3 and current regulation?

Currently several different accounting regulations need to be applied. How large the difference will be with K3 depends on which rules the entity applies today. For entities that apply RR1-RR 29 from Redovisningsrådet in full, the changes will not be as large as for entities that have adopted only Bokföringsnämnden's standards.

The most important differences compared to current regulations are explained below.

Consolidated accounts
The principles for consolidated accounts are based on the economic entity view. The economic entity view differs from the principles for consolidated accounts in RR1:00 Koncernredovisning. RR1:00 reflects consolidated accounts with a majority shareholder (parent) view, whereas the economic entity view reflects the group as a whole, disregarding the owner structure.

For goodwill, K3 requires the use of a so-called 'full-goodwill method'. This implies that goodwill related to minority owners is included in the consolidated accounts. According to ÅRL, goodwill is amortised over a maximum of five years, unless a longer period can be determined with a reasonable degree of precision. According to K3, goodwill cannot be amortised over a longer period than 10 years.

The acquisition date is the date when the parent obtains control over the subsidiary. On this date the purchase price is allocated to the acquired assets and liabilities. The economic entity view implies that 100 per cent of the acquiree's identifiable assets and liabilities are measured at fair value, even if the entity acquires less than 100 per cent. The full-goodwill method means, as noted above, that the minority owner's share of goodwill is also included in the consolidated balance sheet. The minority's share of equity may be measured at the relative share of the price in the most recent transaction. In the consolidated accounts, equity is divided into the majority's share and the minority's share.

The economic entity view implies that as long as a parent-subsidiary relationship exists before and after the parent increases or decreases its ownership, the changes are viewed as transactions between owners. If the parent reduces its ownership to a level where control is lost and the subsidiary becomes an associate, the transaction is treated as if the subsidiary was sold and an interest in an associate acquired. The interest in the associate is measured at fair value and the gain or loss on derecognition of the subsidiary is recognised in the consolidated income statement. The same applies if a disposal of an interest in an associate results in a loss of significant influence and the asset becomes a financial asset.

In the same way, a remeasurement to fair value is made if an entity's increase in ownership of an associate results in it becoming a subsidiary. It is also worth noting that K3 does not allow the pooling method for consolidation.

K3 in brief

K3 is Bokföringsnämnden's standard on financial statements (both annual report and consolidated statements; BFNAR 2012:1). The new regulation was issued on 8 June 2012.

K3 is to be applied in financial statements (both annual report and consolidated statements) for financial years that begin after 31 December 2013, but may be applied earlier.

Property, plant and equipment – components
K3 requires that property, plant and equipment with major components with significantly different useful lives are divided into these components and that each component is depreciated over its useful life. As a consequence, the carrying amount of property, plant and equipment at the date of transition is to be split on the different components. That is, if a property's major components have significantly different useful lives, the property needs to be divided into these components.

Additional new components and replacement of components are added to the carrying amount. Any remaining carrying amount of a replaced component is derecognised. Repairs and maintenance is recognised as expense in the income statement.

Disclosures about investment property
According to K3, an entity shall disclose certain information for investment property, for example fair value. The disclosure is presented on an aggregated level and is not required if the value cannot be measured reliably or if the information cannot be prepared without undue cost.

Lease contracts
In the consolidated accounts, a lessee recognises finance leases as if the asset was acquired with borrowed funds, that is, as an asset and a liability. A lessor recognises finance lease contracts as receivables. In its separate financial statements a legal entity may, however, choose to recognise finance lease contracts as operating leases. K3 also requires disclosures of future lease payments for operating leases, which, for example, includes future payments for rent of offices.

Intangible assets
K3 allows entities to recognise development costs as intangible assets. The decision is an accounting policy choice. The principles are based on RR 15 Intangible assets – costs may be recognised as an asset if certain specified criteria are met. Costs previously recognised as expense in a financial report may, however, not be recognised as an asset at a later date. This is also the case in the event that an entity changes accounting policy from recognising development costs as expense to recognising the costs as an intangible asset.

Amortisation of intangible assets is, as before, recognised over the asset's useful life. The main principle in ÅRL is five years, but the useful life of assets that arise from contractual or other legal rights can be amortised over the period of the contract. Other assets, such as goodwill, may not be amortised over a longer period than 10 years. If the amortisation period exceeds five years, the motive for the use of the longer period needs to be disclosed in the financial report.

Impairment and provisions
The chapters that deal with impairment and provisions respectively do not differ significantly from RR16 and RR 17 issued by Redovisningsrådet. It can, however, be noted that Bokföringsnämnden, in the chapter on impairment, has specified what is meant by a decrease in value being deemed permanent (bestående värdenedgång).

K3 – background

K3 is part of Bokföringsnämnden's K-project. K stands for category (Swedish: kategori) of standards. In the development of K3, IASB's "IFRS for Small and Medium-Sized Entities" (IFRS for SMEs) was used as a basis. As the title indicates, the IASB's intention with IFRS for SMEs is to create a set of standards for small and medium-sized entities. The structure of K3 and its chapters mostly follows the structure of IFRS for SMEs, but deviates in some aspects. Other bases for the development of K3 were existing standards, practice, and the Income Tax Act.

Pensions
K3 requires that every entity determines whether their pension plans are defined benefit pension plans or defined contribution pension plans. For defined benefit pension plans, the entity has the possibility to make an accounting policy choice in the consolidated accounts. The entity can apply IAS 19 paragraphs 57-131, with recognition directly in equity of items that in accordance with IAS 19 are recognised in other comprehensive income, or choose the following simplified principles:

- A defined benefit pension plan where a pension premium is paid may be treated as a defined contribution pension plan.
- If a pension obligation has been secured through transfers of funds to a pension foundation, a provision is recognised only if the foundation's assets, measured at market value, are smaller than the obligation.
- If a pension obligation only depends on the value of an asset owned by the entity, the provision for the pension obligation is measured at the asset's carrying amount.
- If a pension plan is financed in-house, the pension obligation is measured in accordance with the information received from an independent entity, for example PRI (a mutual pension guaranteeing insurance company).
- A pension obligation in a foreign subsidiary is accounted for as in the subsidiary.

A pension obligation may never be recognised as a contingent liability

Income tax
According to K3, all entities are to recognise deferred taxes regardless of the entity's size. As a main principle, the tax is always measured at nominal amount and based on the current tax rate. K3, however, includes an exception from that principle for some net asset deals (rena substansförvärv), where the deferred tax may be measured at the present value. This exception applies only if the value of the deferred tax liability is an essential part of the business deal and there is a documented relation between the acquisition price and the buyer's valuation of the deferred tax liability. This type of net asset deal (rent substansförvärv) is an acquisition of interests in an entity with buildings or land as the primary identifiable assets and where the acquisition price as good as exclusively concerns buildings or land, with deduction for property loan.

Share-based payments
K3 requires recognition of share-based payments. When a share-based payment is to be settled with equity instruments of the entity, the share-based payment is recognised as expense in the income statement and directly in equity. When a share-based payment is to be settled with cash of an amount that depends on the value of equity instruments of the entity, the share-based payment is recognised as expense in the income statement and as a liability. The chapter on share-based payments is a simplification of IFRS 2 and is adapted to Swedish conditions.

Equity
Issued convertible debt is, in the issuing company, split on an equity and a liability component. The split may not be changed subsequently.

Contract work in progress
Contract work in progress on a cost plus contract is recognised as work progresses and materials are delivered or consumed (percentage of completion). Contract work in progress on a fixed price contract is in the consolidated accounts recognised in accordance with percentage of completion if the outcome of the project can be measured reliably. If the outcome cannot be measured reliably revenue is recognised to the extent of contract costs incurred, which are recognised as expense in the period they are incurred. In the separate financial statements of legal entities income from contract work in progress at fixed price may alternatively be recognised at completion (completed contract).

Only one alternative exists for accounting for cost plus contracts, 'huvudregeln', which is different from tax regulation where an alternative method is allowed, 'alternativregeln'.

Administration report (management commentary)
Requirements for the administration report are specified in chapter 3. The requirements may seem extensive, but they are basically the same as in the current standards on the content of the administration report (U 96:6 Förvaltningsberättelsens innehåll and U 98:2 Miljöinformation i förvaltningsberättelsen).

Capital contribution and group contribution
A contribution given by an owner without receiving any equity instruments is recognised as an increase in the value of the interest. A contribution received by an entity from its owner without exchanging equity instruments is recognised as an increase in equity. A repayment of received contribution is recognised as a mirror picture.

Group contribution, according to chapter 35 in the Income Tax Act, is, however, recognised as an appropriation (bokslutsdisposition). Group contribution from a parent to a subsidiary may be recognised as an increase in the value of the interest.

Disclosures about employees and salaries
Disclosure requirements regarding employees are the same as in K2 and differ to some extent from today's standard on number of employees and employee compensation (R4 Uppgift om medelantalet anställda samt löner och andra ersättningar). For example, the new disclosure requirements on salaries and other compensation regard expenses for taxable compensation instead of expenses reflecting the work performed as in R4.

Change in accounting policies and correction of error
The requirements regarding change in accounting policies etc. are in principle the same as those issued by Redovisningsrådet, except for the additional requirements in K3 on correction of errors in previous financial reports. According to K3 errors are corrected retrospectively. Financial reports for the comparative year are changed in accordance with how the accounting should have been done and errors made in previous years are corrected in the opening balance of the comparative year. The requirement is the same for financial reports of both a group and a legal entity. A new financial report is not prepared for the year when the error was made.

Financial instruments
The requirements for financial instruments depend on if the entity has chosen to apply ÅRL's possibility to measure financial instruments at fair value (see ÅRL chapter 4 paragraph 14 a) or not. That accounting policy choice determines which chapter should be applied. Both chapter 11 and 12 contain requirements for measurement and for hedge accounting (for example requirements on documentation of hedging relationships). Chapter 12 should be applied on all financial instruments if the entity chooses to measure at fair value.

First-time adoption of K3

Chapter 35 contains requirements about first-time adoption of K3. The main principle is retrospective application of K3's requirements. There are some optional and some mandatory exceptions from this. The comparative year presented in the first K3-based financial report (including disclosures) is also required to be in accordance with K3.

Date of transition is the first day of the earliest financial year that the entity presents comparative financial statements for. An opening K3 balance sheet is prepared as at the date of transition. The main principle is, as noted above, that items in the opening K3 balance sheet are recognised with retrospective application of K3's accounting policies.

Retrospective application is, however, not allowed in the following cases:

- Estimations and judgements made before the date of transition may not be changed.
- Expenditures for internally generated intangible assets which have been expensed previously may not be recognised as an asset.
- Amortisation of goodwill may not be restated.
- Property, plant and equipment that are to be divided into components are not to be restated retrospectively, but to be divided into components at the date of the transition.
- Governmental and other public contribution that has not been recognised as a reduction of an asset's acquisition cost may not be restated by reducing the carrying value on the date of transition.
- Borrowing costs that have been recognised as expense may not be included in the acquisition cost of assets.

Retrospective application is optional in the following cases:

- Group contributions that have not been recognised as appropriations need not be reclassified.
- Indirect production costs not included in the acquisition cost of an asset do not have to be included.
- The chapter on business combinations does not need to be applied for acquisitions made before the date of transition. If the entity decides to retrospectively apply the chapter on business combinations on an acquisition before the date of transition, the business combinations chapter needs to be applied to all acquisitions having taken place after that acquisition.
- Share-based payments granted before the date of transition do not need to be recognised in accordance with chapter 26.
- Deferred tax does not need to be recognised in the opening K3 balance sheet if this information cannot be presented without undue cost.
- Finance lease contracts previously recognised as operating lease contracts do not need to be restated retrospectively, but may be recognised on the date of transition at the lease contract value on that date.
- Expenditures for dismantling, removal or restoration of site that according to chapter 17 (property, plant and equipment) is included in the acquisition cost may be measured as at the date of transition.

If retrospective application of K3 is impracticable for some item(s) in the opening K3 balance sheet (for example 1 January 2013), K3 is retrospectively applied from the opening date of the reporting period (for example 1 January 2014). The fact that K3 is applied for the first time and the optional exemptions from retrospective application used are disclosed.

First-time adopters need to specify in a note which accounting policies have been changed and present a reconciliation of opening equity.

Why K3?

A larger entity that does not apply IFRS in its consolidated financial statements may currently apply different accounting rules. In the K-project Bokföringsnämnden compiles all rules that an entity should apply when preparing an annual report (and consolidated accounts) in one guidance. Bokföringsnämnden has also changed the structure used within its guidance. There is now text from a legal act, directly followed by the main standard text (allmänt råd) that interprets the act and by the related comments (kommentarer). The aim is to facilitate the reading and application. In addition, all definitions are listed in an attachment.

K3 is principles based. Chapter 2 consists of a framework with concepts and principles. The chapter covers fundamental principles and measurement bases and includes definitions of and criteria for the recognition of assets, liabilities, revenues and expenses. Chapter 2 points out that the objective of a financial report is to provide information regarding the entity's financial position, financial performance and cash flows. The information is intended to be useful for the user in making economic decisions.

What happens if an issue is not regulated?

K3 is intended to be comprehensive. If guidance within K3 for a transaction or event is inadequate, further guidance should first be sought in K3 guidance for similar transactions, events and circumstances. Secondly, guidance should be sought in the framework in chapter 2 – in the definitions, fundamental principles and principles for measurement and recognition of assets, liabilities, income and expenses. Since K3 is principles based, non-regulated issues can normally be solved based on chapter 2. If guidance is still not found, guidance should be sought in IFRSs. This is expected to occur only in rare cases.

Foundations and non-profit associations

Special principles for foundations and non-profit associations are found in chapters 36 and 37. These chapters include, for example, principles for accounting for gifts and received financial contributions. There is also a simplification for impairment of an asset that is held for the purpose of the foundation/association. These chapters should be read first since there are special principles that apply instead of the principles in chapters 1-35.

Smaller entities that apply K3

The measurement principles in K3 are the same for all entities. This, for example, implies that all entities applying K3 should recognise deferred tax. Smaller entities do, however, not need to apply the disclosure requirements in ÅRL that are required for larger entities. For example, smaller entities are not required to disclose a cash flow statement or prepare consolidated accounts. However, smaller entities are required to apply the disclosure requirements in K3, for example regarding fair value of investment property and future lease payments.

Differences between K2 and K3

Smaller entities can choose whether to prepare the annual report in accordance with K2 or K3. So what are the differences? K2 is based on rules – "do this" – while K3 is based on principles and leaves more room for adaptation to the special situation – "think like this". K2 is adapted for smaller entities with relatively uncomplicated business activities and few or no external capital providers. K3 is aimed at larger entities and more complex business activities.

In K2 the only incomes statement form allowed is based on classification by nature of expense and, additionally, there are detailed schedules for the administration report, income statement and balance sheet with explicit requirements for the content of each item.

An area of significant difference between K2 and K3 is the disclosure requirements. In K2, entities are only required to state that the annual report is prepared in accordance with K2 and to include disclosures required by ÅRL. In K3, entities are required to describe the significant accounting principles applied, for example regarding revenue recognition, consolidation, financial instruments, leasing, and provisions.

K2 is based on the prudence principle, which for example means that financial instruments may not be measured at fair value, possibilities to revalue assets are limited and it is not allowed to recognise internally generated intangible assets. The corresponding limitations do not exist in K3.

Is it necessary to choose?

Yes. There is no abstainer alternative. The current standards from Bokföringsnämnden and Redovisningsrådet will cease to apply for limited companies and cooperative associations on 1 January 2014.

Do you want to know more?

K3 is extensive and preparations for the transition require time. KPMG regularly arranges breakfast seminars and education days regarding K3. Of course, we also offer individual support adapted to your particular needs.

Do you want to know more about how we can help you and your entity with issues concerning K2 or K3? Contact Catharina Pramhäll at +46 8 723 93 14 or catharina.pramhall@kpmg.se.

The complete K3 standard can be downloaded at Bokföringsnämnden's website: www.bfn.se.

kpmg.se/k2k3