



*cutting through complexity*

# Cutting through UK GAAP

KPMG's guide to the new  
financial reporting regime

Second edition

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# Foreword

New UK GAAP is now in force, applicable for periods beginning or after 1 January 2015; we are now within the first period of mandatory application.

New UK GAAP replaces the previous, long-standing UK accounting standards and comprises a multiplicity of separate accounting frameworks, all of which are part of New UK GAAP. Much of their effect will be comfortable and familiar, but there is also much change.

Entities that were previously required to apply EU-IFRS by applicable law and regulation continue to do so. Other entities are able, subject to eligibility, to choose to prepare their financial statements in accordance with EU-IFRS, FRS 101, FRS 102 (including, when relevant, FRS 103), the FRSSE (replaced for periods beginning on or after 1 January 2016 by FRS 102 with a different disclosure regime for small entities), or the micro-entities standard (FRS 105). For subsidiaries of entities preparing EU-IFRS consolidated financial statements, the application of FRS 101 in particular allows the use of accounting policies that are more consistent with those of the group, without the perceived burden of applying the full disclosure requirements of EU-IFRS. Groups can elect for some of their subsidiaries to apply FRS 101 and others FRS 102, since both will be 'Companies Act accounts'.

If they have not already done so, those charged with governance will need to make important decisions about which accounting framework to apply. This will require not only consideration of the available accounting options, but also assessment of the potential effect on accounting systems, staff training, taxation and other arrangements such as loan covenants. They will also need to consider the potential effect on distributable profits. In this publication, we summarise the requirements of each of the new standards FRSs 100, 101, and 102. In addition, we highlight the key accounting differences between FRS 102, previous UK GAAP and EU-IFRS, in order to inform those deciding which standards to apply and to ease the transition to FRS 102 for those that choose to apply that standard. We do not discuss the requirements of FRS 103 *Insurance Contracts* in any detail but do consider its scope and principal differences from previous UK GAAP and EU-IFRS.

In this, the second edition of this publication, we have included examples to illustrate the application of the requirements of FRS 102, as well as our interpretation of those requirements in a number of areas in which the standard is not explicit, necessitating judgement to apply them appropriately. As FRS 102 is a new financial reporting framework, common practice and interpretation continue to evolve and we will update future editions of this publication to reflect that body of experience as it develops, which may be influenced both by past UK GAAP practice and evolving IFRS application.

A new GAAP, applicable to tens of thousands of entities all at once, is an exciting and challenging prospect. 2015 will be a year of both choice and reckoning for many as they navigate those changes. We trust that this publication will assist you in understanding those choices and we look forward to helping you to rise to the challenge.

Tony Cates

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## About this publication

This publication summarises and discusses the requirements of FRS 100, FRS 101 and FRS 102 and notes the main differences between FRS 102, previous UK GAAP and EU-IFRS. It does not consider either the micro-entities standard (FRS 105) or the FRSSE (or its replacement, new Section 1A *Small Entities* of FRS 102). It also does not discuss the disclosure requirements of FRS 102 in any detail. It includes consideration of the scope of FRS 103 and the principal differences from EU-IFRS and previous UK GAAP.

Although it includes an overview of the requirements of FRSs 100 to 102, this publication is an interpretative guide to those FRSs that builds on the standards and should be read alongside them.

When the standards are silent on a particular matter, we discuss different acceptable accounting treatments. We use the phrase 'in our view' if we believe that only one accounting treatment is appropriate.

The publication is organised into chapters that generally correspond to the relevant section of FRS 102 (Chapters 3 to 35).

Chapters 1 and 2 consider FRS 100 and FRS 101 respectively; Chapter 36 considers FRS 103.

This publication includes the following paragraph/section references:

- x.x (e.g. 3.1) – paragraph of the main body in this publication
- pUKx.x (e.g. pUK3.1) – paragraph of comparison to previous UK GAAP in this publication
- IFRSx.x (e.g. IFRS3.1) – paragraph of comparison to EU-IFRS in this publication
- FRS10x.x.x (e.g. FRS102.3.1) – paragraph of the relevant standard
- FRS10x.ACA.xx (e.g. FRS102.ACA.92) – paragraph of Accounting Council's Advice on the relevant standard
- FRS10x.GL – glossary of the relevant standard
- FRC CS ddmmy – FRC clarification statement and relevant date of issue
- FRC SENxx - FRC staff education note and number
- Chapter x (e.g. Chapter 3 *Scope, concepts, principles and presentation*) – chapter in this publication
- Section x (e.g. Section 3 *Financial statement presentation*) – section of the standard FRS 102

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## Other ways KPMG professionals can help

This publication has been produced by UK DPP. There is a range of publications and guidance published by UK DPP and KPMG IFRG Limited that is available to assist you further, including:

- Illustrative financial statements prepared under each of FRS 101 and FRS 102
- *Insights into IFRS* – provides practical guidance on the application of IFRS
- *IFRS Handbooks* – include extensive interpretative guidance and illustrative examples to elaborate on or clarify the practical application of IFRS
- e-learning modules on FRSs 100-102 from the KPMG Learning Academy.

For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG's Accounting Research Online. This web-based subscription service can be a valuable tool for anyone who wants to stay informed in today's dynamic environment. For a free 15-day trial, go to [www.aro.kpmg.com](http://www.aro.kpmg.com) and register today.

For further information see [kpmg.com/uk](http://kpmg.com/uk) or [kpmg.com/ifrs](http://kpmg.com/ifrs).

## Abbreviations

'Companies Act' – Companies Act 2006

'EU-IFRS' – International Financial Reporting Standards as adopted by the European Union

'FRC' – Financial Reporting Council, the UK regulator that issues UK accounting standards

'FRS' – Financial Reporting Standard

'FRSSE' – Financial Reporting Standard for Smaller Entities

'GAAP' – Generally Accepted Accounting Practice/Principles

'IAS' – International Accounting Standard

'IFRIC' – IFRS Interpretations Committee (previously the International Financial Reporting Interpretations Committee)

'IFRS' – International Financial Reporting Standard

'Insights into IFRS' – KPMG's Insights into IFRS publication

'LLP' – Limited Liability Partnership

'LLP Regulations' – Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008, Statutory Instrument 2008/1911

'Regulations' – The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations, Statutory Instrument 2008/410

'SIC' – Standing Interpretations Committee

'SORP' – Statement of Recommended Practice

'SSAP' – Statement of Standard Accounting Practice

'UITF' – Urgent Issues Task Force

'UK GAAP' – United Kingdom Generally Accepted Accounting Practice

## Introduction

INT.1 The financial reporting standards for the UK and Republic of Ireland have been revised for periods beginning on or after 1 January 2015. All of the standards in previous UK GAAP either have been or, in the case of the FRSSE, will be replaced by four standards:

- FRS 100 Application of Financial Reporting Requirements (as updated July 2015)
- FRS 101 Reduced Disclosure Framework (as updated August 2014 and July 2015)
- FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland (as updated August 2014, February 2015 and July 2015)
- FRS 103 Insurance Contracts

INT.2 These FRSs bring UK GAAP up to date and increase consistency with International Financial Reporting Standards.

INT.3 FRS 100 sets out the financial reporting requirements for UK and Ireland entities preparing financial statements that are intended to give a true and fair view. See Chapter 1 of this publication.

INT.4 FRS 101 sets out a reduced disclosure framework that may be applied in the individual financial statements of qualifying group entities that otherwise apply the requirements of EU-IFRS. See Chapter 2 of this publication.

INT.5 FRS 102 is a single standard providing concise financial reporting requirements, based on the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) as amended for use in the UK and Ireland. It replaces the previous body of UK GAAP accounting standards. See Chapters 3 to 35 of this publication.

INT.6 In July 2015 the FRC issued amendments to FRSs 100 to 102, the majority of which are effective for periods commencing on or after 1 January 2016, although some are effective for periods commencing on or after 1 January 2015. The key amendments are discussed in the relevant chapters of this publication as follows:

- Changes that are effective from 1 January 2016 are either discussed in the main chapter text or included as footnotes to the currently effective requirements.
- Changes that are effective from 1 January 2015 are discussed in the main chapter text.

INT.7 Early-adoption of the July 2015 amendments, and the new requirements for small and micro-entities (see paragraph INT.11 below), is permitted for periods commencing on or after 1 January 2015, provided that (for companies) the corresponding changes to the Companies Act as a result of changes in the EU Accounting Directive (see SI 2015/980) are also early-adopted. Similarly, early-adoption of the amendments is required if a company chooses to early-adopt the changes to the Companies Act.

INT.8 FRS 103 replaces FRS 27 and the SORP *Accounting for Insurance Business*. The scope of this standard is not restricted to insurance entities; it applies to any entity applying FRS 102 with any of the following:

- insurance contracts (including reinsurance contracts) issued;
- reinsurance contracts held by the entity;
- financial instruments with a discretionary participation feature issued by the entity. [FRS102.1.6]

INT.9 FRS 104 *Interim Financial Reporting* sets out requirements for interim financial reports prepared by FRS 101 and FRS 102 adopters. FRS 104 is not addressed in this publication.

INT.10 The FRSSE may be applied by entities meeting the small companies' exemptions of the Companies Act, or entities that are not companies but would otherwise be entitled to those exemptions if they had been incorporated under the Companies Act.

INT.11 The FRSSE is withdrawn for periods beginning on or after 1 January 2016, and replaced by:

- For micro-entities: a new standard, FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*;
- For small entities that are not micros: new Section 1A *Small Entities* of FRS 102. This requires small entities to apply the recognition and measurement requirements of FRS 102 but with a different disclosure regime, reflecting the fact that the EU Accounting Directive limits the number of specific disclosures that may be mandated for small entities. The financial statements of small entities are nevertheless still required to give a true and fair view, which may require judgement to be exercised over the appropriate level of disclosure.

INT.12 The detailed requirements of Section 1A of FRS 102 and FRS 105 are not addressed in this publication.

# 01 Application of financial reporting requirements

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## OVERVIEW OF REQUIREMENTS

- Depending on eligibility and legal and regulatory requirements, UK and Ireland private sector entities apply EU-IFRS, FRS 101 or FRS 102 (with or without reduced disclosures and including, when relevant, FRS 103), the FRSSE or, for periods beginning on or after 1 January 2016, its replacement for small entities, Section 1A of FRS 102 or FRS 105 in preparing their annual financial statements.
  - An entity applying FRS 102 also applies a SORP if required or relevant.
  - An entity states the framework it is applying in the notes to its financial statements.
  - FRSs 100, 101 and 102 are applicable for periods beginning on or after 1 January 2015. Early-adoption is permitted subject to certain conditions.
  - FRS 102 with a different disclosure regime for small entities and FRS 105 (the micro-entities standard) replace the FRSSE for periods beginning on or after 1 January 2016. Early-adoption is permitted for periods beginning on or after 1 January 2015 subject to early-adoption also of the related legal changes (see paragraph INT.7 of this publication).
  - Transitional requirements are as specified in FRS 100, FRS 101 and FRS 102.
  - Qualifying entities within a group may apply a reduced disclosure framework in their individual financial statements under FRS 101 or FRS 102.
  - Guidance on 'equivalence' is given in the Application Guidance to FRS 100.
  - FRS 104 sets out requirements for interim financial reports prepared by FRS 101 and FRS 102 adopters. FRS 104 is not addressed in this publication.
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1.1 FRS 100 sets out the financial reporting requirements for UK and Ireland entities preparing financial statements that are intended to give a true and fair view. [FRS100.2] It does not, however, apply to the financial statements of entities within the public sector<sup>1</sup>, whose financial reporting framework is determined by the Relevant Authorities<sup>2</sup> and is generally based on EU-IFRS as adapted for use in the public sector (see the Foreword to Accounting Standards paragraph 21).

1.2 Annual financial statements within the scope of FRS 100 are prepared, depending on eligibility, in accordance with either EU-IFRS, FRS 101, FRS 102, or the FRSSSE<sup>3</sup>. [FRS100.4]

1.3 EU-IFRS is applied when required by law or regulation (for example, in the consolidated financial statements of companies listed on an EU-regulated market or AIM companies).

1.4 FRS 101 sets out a reduced disclosure framework that may be applied in the individual financial statements of qualifying group entities (see paragraph 1.24 of this publication) that otherwise apply the requirements of EU-IFRS. This framework is discussed further in Chapter 2 of this publication.

1.5 FRS 102 (including, when relevant, FRS 103) replaces the previous body of UK GAAP standards and is discussed in Chapters 3 to 35 of this publication (see Chapter 36 for a discussion of FRS 103). It also includes disclosure exemptions for qualifying group entities.

### Basis of preparation of financial statements

1.6 The applicable standards are summarised in the following table. Any entity can 'trade up' and apply a 'higher' standard (e.g., an entity currently eligible to apply the FRSSSE may choose instead to apply FRS 102).

Accounting regime	Applicable to	Example	Further guidance
EU-IFRS	<ul style="list-style-type: none"> <li>Those required to apply by law or regulation</li> <li>Optional for others</li> </ul>	<ul style="list-style-type: none"> <li>Group financial statements of EU listed and AIM entities</li> <li>Large private group or company</li> </ul>	KPMG's <i>Insights into IFRS</i>
FRS 101 <sup>4</sup>	<ul style="list-style-type: none"> <li>Individual financial statements of qualifying parent and subsidiary entities</li> </ul>	<ul style="list-style-type: none"> <li>Parent company in a listed or private group</li> <li>Subsidiaries in a listed or private group</li> </ul>	Chapter 2 of this publication; see also paragraphs 1.24-1.35 for eligibility
FRS 102 <sup>4,5</sup>	<ul style="list-style-type: none"> <li>Individual and group financial statements of large and medium-sized entities</li> <li>Individual and group financial statements of small entities choosing not to apply FRSSSE</li> </ul>	<ul style="list-style-type: none"> <li>Large and medium private companies and groups</li> <li>Parent company in a listed or private group</li> <li>Subsidiaries in a listed or private group</li> </ul>	Chapters 3 to 36 of this publication
FRS 102 <sup>4,5</sup> with reduced disclosures	<ul style="list-style-type: none"> <li>Individual financial statements of qualifying parent and subsidiary entities</li> </ul>	<ul style="list-style-type: none"> <li>Parent company in a listed or private group</li> <li>Subsidiaries in a listed or private group</li> </ul>	Chapters 3 to 36 of this publication; see also paragraphs 1.24-1.35 for eligibility
FRSSSE <sup>3</sup>	<ul style="list-style-type: none"> <li>Eligible small entities</li> </ul>	<ul style="list-style-type: none"> <li>Small private companies</li> <li>Small non-company entities</li> </ul>	See INT.10 for eligibility

1. The public sector includes those entities classified as such by the Office for National Statistics.

2. The Relevant Authorities in the UK are: HM Treasury, the Welsh Assembly Government, the Scottish Government, the Northern Ireland Assembly, CIPFA/LASAAC, the Department of Health and Monitor (Independent Regulator for NHS Foundation Trusts).

3. In July 2015, the FRC withdrew the FRSSSE for periods beginning on or after 1 January 2016 and replaced it with FRS 105 and, for small entities that are not

micro-entities, FRS 102 with a different disclosure regime for small entities (Section 1A of FRS 102). Early-adoption is permitted for periods beginning on or after 1 January 2015, subject to early-adoption also of the related legal changes (see paragraph INT.7 of this publication).

4. FRS 104 sets out requirements for interim financial reports prepared by FRS 101 and FRS 102 adopters. FRS 104 is not addressed in this publication.

5. Including, when relevant, FRS 103.

### Interaction with Companies Act requirements

1.7 Financial statements of a company prepared in accordance with FRS 101, FRS 102 (with or without reduced disclosures) or the FRSSE (or its replacements) are 'Companies Act accounts' as defined by section 395 of the Companies Act. Only those prepared under EU-IFRS are 'IAS accounts'.

1.8 The Companies Act specifies that charitable companies prepare 'Companies Act accounts' so they are not eligible to apply EU-IFRS in their individual or group financial statements. They are also not eligible to apply FRS 101 as the definition of a qualifying entity under that standard excludes charitable companies.

1.9 Section 407 of the Companies Act requires the individual financial statements of UK subsidiary companies within a group, when the parent prepares consolidated financial statements, to be prepared on a consistent basis (i.e. all Companies Act accounts or IAS accounts) unless there are good reasons not to<sup>6</sup>. The individual financial statements of the parent company are prepared on the same basis as those of the subsidiaries except when the parent company prepares IAS group accounts and IAS individual accounts. As only individual financial statements prepared under EU-IFRS are considered to be IAS accounts, it is possible for different subsidiaries within a group to apply FRS 101 and FRS 102 (and, if eligible, the FRSSE or its replacements) in their individual financial statements without breaching the Companies Act consistency requirement.

1.10 Previously, once a company had prepared its consolidated or individual financial statements under EU-IFRS, it could not revert to UK GAAP in a later financial year unless there was a specified 'relevant change in circumstances' (e.g. if the company (or its parent) ceased to have its securities admitted to trading on a regulated market in an EEA<sup>7</sup> state [Companies Act sections 395 and 403]). Changes to the Companies Act (for periods ending on or after 1 October 2012) introduced a free choice for a company to revert to UK GAAP (which includes FRS 101 and FRS 102) from EU-IFRS as long as it has not in the last five years previously reverted to UK GAAP (other than as a result of a relevant change in circumstances).

1.11 Certain requirements of the Companies Act apply even when the financial statements are prepared in accordance with EU-IFRS. This includes disclosures in relation to related undertakings and directors' benefits, and the requirement to prepare a strategic report, a directors' report and (if applicable) a directors' remuneration report. [FRS100.A2.18-19]

### Non-companies

1.12 Many entities applying FRS 100 are not companies and will need to consider whether there are any conflicts with the legislation or regulation applicable to them. [FRS100.A2.20] The FRC has considered the legislation for the form and content of financial statements for the following and has concluded that there are no significant areas of conflict with FRS 102:

- Building Societies Act 1986;
- Charities Act 2011;
- Charities and Trustee Investments Act (Scotland) 2005;
- Charities Act (Northern Ireland) 2008;
- Friendly and Industrial and Provident Societies Act 1968 (superseded by the Co-Operative and Community Benefit Societies Act 2014 with effect from 1 August 2014);
- Friendly Societies Act 1992; and
- The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996.

1.13 Certain entities may be required to comply with additional regulations on top of the legal requirements and accounting standards, and some fall within the scope of SORPs, which have been updated to reflect the requirements of FRS 102. [FRS100.A2.21]

6. Charitable companies are not permitted to prepare IAS accounts and are not required to apply the same financial reporting framework as non-charitable subsidiaries.

7. The European Economic Area (EEA) comprises the countries of the European Union (EU), plus Iceland, Liechtenstein and Norway. It does not include the Channel Islands, the Isle of Man, or Gibraltar.

### Statements of recommended practice (SORPs)

1.14 SORPs are intended to improve comparability between entities within a sector. In developing its accounting policies, an entity applying FRS 102 or the FRSSE (withdrawn for periods beginning on or after 1 January 2016) may apply a SORP if it is in scope of that SORP (or may be required to do so by applicable law or regulation) or may choose to apply a SORP that is relevant to it provided the SORP does not conflict with the requirements of the accounting standard applied. If an entity applies a SORP it states this in its financial statements. Any departures from the accounting or disclosures of the SORP are disclosed. [FRS100.5-8, FRS102.10.5] Small entities applying Section 1A of FRS 102 are not required to give these disclosures but are encouraged to do so.

### Statement of compliance

1.15 An entity includes a statement of compliance in the notes to its financial statements specifying whether it is applying FRS 102, the reduced disclosure framework of FRS 102, FRS 101 or the FRSSE (withdrawn for periods beginning on or after 1 January 2016). Entities applying full EU-IFRS are required by IAS 1.16 to give an equivalent statement of compliance. [FRS100.9] Small entities applying Section 1A of FRS 102 are not required to give a statement of compliance but are encouraged to do so. FRS 105 does not require a statement of compliance for micro-entities. However, when the accounts are prepared under the small companies regime (including the micro-entities regime), s414(3) of the Companies Act requires this to be stated on the balance sheet.

### Effective date and transition

1.16 FRSs 100, 101 and 102 are applicable for periods beginning on or after 1 January 2015. Early-adoption is permitted. [FRS100.10] However, early-adoption of FRS 101 may be restricted for companies that previously applied EU-IFRS in their individual financial statements to periods ending on or after 1 October 2012 (see paragraph 1.10 of this publication). In addition, early-adoption of FRS 102 is restricted to periods ending on or after 31 December 2012 and, for entities within the scope of a SORP, early-adoption of FRS 102 is permitted only if the standard does not conflict with the requirements of a current SORP or legal requirements for the preparation of financial statements.

1.17 In July 2015, the FRC withdrew the FRSSE for periods beginning on or after 1 January 2016 and replaced it with FRS 105 and, for small entities that are not micro-entities, FRS 102 with a different disclosure regime for small entities (Section 1A of FRS 102). Early-adoption is permitted for periods beginning on or after 1 January 2015 subject to early-adoption also of the related legal changes (see paragraph INT.7 of this publication).

1.18 On transition an entity applies the following: [FRS100.11]

- for transition to EU-IFRS – IFRS 1 – see *Insights into IFRS* Chapter 6;
- for transition to FRS 101 unless the entity previously applied EU-IFRS – IFRS 1 paragraphs 6-33 as amended by FRS 101.5(b) – see paragraph 2.14 of this publication;
- for transition to FRS 101 when the entity previously applied EU-IFRS – the entity does not reapply IFRS 1 but considers whether adjustments are necessary to comply with FRS 101.5(b) [FRS100.12] – see paragraph 2.15 of this publication;
- for transition to FRS 102 – the requirements in Section 35 *Transition to FRS 102* – see Chapter 35 of this publication;
- for transition to the FRSSE (to be withdrawn for periods beginning on or after 1 January 2016) – there are no specific transition requirements in the FRSSE. An entity applying the FRSSE for the first time would therefore need to apply all FRSSE requirements retrospectively for any transactions or balances in the financial statements at the date of transition, except to the extent that any parts of the standard applied prospectively from a specific date. Note that FRS 100 introduced changes to the FRSSE, resulting in a new version of the FRSSE (effective January 2015) that is outside the scope of this publication;
- FRS 105 includes transition requirements in Section 28 of the standard.

1.19 FRS 100 does not specifically address moving between FRSs 101 and 102. We would expect this to be dealt with similarly to a change in accounting policy since it would be changing from one version of UK GAAP to another. It would therefore be necessary to consider whether the new accounting would provide more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows [IAS8.14(b); FRS102.10.8(b)]. This could be a high hurdle to overcome.

## Equivalence

1.20 FRS 100 includes application guidance on equivalence both for the purpose of considering exemption from consolidation under section 401 of the Companies Act and for the purpose of the disclosure exemptions potentially available under FRS 101 and FRS 102 (see paragraphs 1.33 to 1.35 of this publication).

1.21 Under section 401 of the Companies Act<sup>8</sup>, a parent company that is the subsidiary of a non-EEA parent may be exempt from preparing consolidated financial statements if (among other conditions) it is included in a higher consolidation that is prepared in a manner 'equivalent' to financial statements prepared in accordance with the EU Accounting Directives.

1.22 The relevant Application Guidance<sup>9</sup>, updated for the revisions to section 401 made in March 2015, indicates that FRS 102 and EU-IFRS will automatically be equivalent for this purpose. Full IFRS will be equivalent subject to consideration of the reason for the difference from EU-IFRS. Section 401 now also indicates that accounting standards that the European Commission has determined can be used by third country issuers of securities in the EU will automatically be considered equivalent. The Commission's list of GAAPs, which is updated on an occasional basis, is currently issued as Directive 2008/961/EC (updated by Directive 2012/194/EU) and includes Japanese, US, Chinese, Canadian, and South Korean GAAPs. For periods beginning on or after 1 January 2015, in relation to Indian GAAP, the Application Guidance states that equivalence should be assessed on the basis of the particular facts. Therefore, those accounting standards can be considered equivalent without further review. Other GAAPs would require specific consideration. This could take the form of a comparison of that GAAP, as applied to the company in question, with EU-IFRS, as a GAAP that complies with the Accounting Directive, or the direct identification of similarities to and differences from the Accounting Directive. In respect of the latter, only the basic requirements of the Accounting Directives are required to be met, in particular the requirement to give a true and fair view; strict conformity with every provision of the Directives is not necessary. [FRS100.AG1-AG7<sup>9</sup>]

## Reduced disclosure frameworks

1.23 FRS 101 and FRS 102 offer reduced disclosure frameworks that may be applied in the individual financial statements of qualifying entities provided certain criteria are met (see paragraphs 1.24 to 1.35 of this publication). The available disclosure exemptions are discussed in Chapters 2 and 3 of this publication. The reduced disclosure frameworks may not be applied in any consolidated financial statements. [FRS101.3, FRS102.1.10]

## Definition of qualifying entity

1.24 A qualifying entity is a member of a group of which the parent prepares publicly available consolidated financial statements that are intended to give a true and fair view and that member is included in the consolidation. [FRS101.GL, FRS102.GL]

1.25 The definition of a qualifying entity for FRS 101 (but not for FRS 102) purposes has additional wording that excludes charities from being qualifying entities. Charitable companies within a group may not apply FRS 101 in their individual financial statements but may (subject to meeting the necessary conditions) apply the reduced disclosures offered for qualifying entities under FRS 102. [FRS101.GL]

1.26 Part of the definition of a qualifying entity under FRS 101 and FRS 102 is that the consolidated financial statements in which the group entity is included are 'intended to give a true and fair view'. This is not a question of whether they do in fact give a true and fair view but whether they are intended to do so, presumably under legal or regulatory requirements. When the GAAP applied in the consolidated financial statements is EU-IFRS, full IFRS or FRS 102, or is considered to be equivalent for the purpose of section 401 of the Companies Act (see paragraph 1.20 of this publication), in our view this condition will be met. For other GAAPs it will be necessary to consult the wording of the applicable legal and regulatory requirements in order to determine whether the consolidated financial statements are intended to give a true and fair view.

1.27 'Included in the consolidation' means that the entity is included in the consolidated financial statements on a full (not proportional) consolidation basis. [FRS101.GL, FRS102.GL] The definition of a qualifying entity includes both subsidiaries and the parent of a group (assuming that the necessary criteria are met). Joint ventures will not be qualifying entities as they are not included in a consolidation on a full consolidation basis. Associates could be qualifying entities if they are subsidiaries of another investor and are included in that investor's consolidation on a full consolidation basis.

8. As revised by The Companies, Partnerships and Group (Accounts and Reports) Regulations 2015 (SI 2015/980), effective for financial years beginning on or after 1 January 2016 although the relevant amended Regulations, along with the related amendments (issued in July 2015) to FRSs 100 to 102, may be early-adopted in full for financial years beginning on or after 1 January 2015.

9. As amended in July 2015.

1.28 The standards do not define ‘publicly available’. We would expect this to include not only situations when the financial statements are available under a recognised statutory framework (for example from a central registry with which all financial statements must by law be lodged), but also when the financial statements are available from the parent entity on the payment of, at most, a nominal sum. The subsidiary’s directors would need to be satisfied that the consolidated financial statements are publicly available.

1.29 We would not expect the consolidated financial statements necessarily to be publicly available at the date of approval of the subsidiary financial statements, provided that the parent is required to make the financial statements publicly available (or has historically done so voluntarily) and there is no reason to expect that it will not do so for the period in question. There is also no requirement in the standards for the consolidation to be prepared for the same reporting period as the individual financial statements of the qualifying entity. However, the consolidated financial statements will need to be available, at least to the preparers and auditors of the subsidiary financial statements, at the date of approval of any subsidiary financial statements seeking to take advantage of disclosure exemptions that are dependent on equivalent disclosures being included in the consolidated financial statements (see paragraphs 1.33 to 1.35 below), so that their equivalence can be assessed.

### Criteria for applying a reduced disclosure framework

1.30 A qualifying entity may apply the reduced disclosure framework of FRS 101 or FRS 102 only if both of the following conditions are met:

- (a) Its shareholders have been notified in writing about, and do not object to, the application of the disclosure exemptions. Only the entity’s immediate parent, or shareholder(s) holding five percent or more of the total allotted shares of the entity or more than half of the allotted shares not held by the immediate parent, are entitled to serve an objection. The entity specifies a reasonable time frame and format for objections. [FRS101.5(a), FRS102.1.11(a)] Whilst this condition may be relatively straightforward to meet in the case of a wholly-owned subsidiary within a group, listed ultimate parent companies may find this condition more challenging logistically. Such companies will need to plan carefully the method by which they will obtain this permission, for example as part of the Annual General Meeting process or via a separate communication with shareholders.
- (b) The financial statements summarise (in narrative form) the exemptions applied and identify the consolidated financial statements in which the entity is consolidated. [FRS101.5(c), FRS102.1.11(c)]

1.31 Neither FRS 101 nor FRS 102 specify the frequency with which entities should notify their shareholders (see (a) above). If an entity’s shareholders and their respective shareholdings have not changed during the year (for example if it is a wholly-owned subsidiary with the same parent year on year) it would not seem necessary to re-notify the shareholders. However, if an entity’s shareholders and/or their respective shareholdings have changed during the year such that the parties that could object to the use of the reduced disclosure framework have changed, it would seem that, in order to achieve compliance with the condition, the entity will need to notify those parties. For practical reasons, an entity may choose to implement a process of annual notification to ensure that it does not breach the requirements of the standard.

### FRS 101 – consequential amendments to EU-IFRS

1.32 Since financial statements prepared in accordance with FRS 101 are Companies Act accounts (see paragraph 1.7 of this publication), qualifying entities applying FRS 101 make certain amendments to the requirements of EU-IFRS in order to comply with the requirements of the Companies Act; these are discussed in Chapter 2 of this publication. [FRS101.5(b)]

### Equivalent disclosures

1.33 Certain (but not all) of the disclosure exemptions available in FRS 101 and FRS 102 are conditional upon equivalent disclosures being included in the consolidated financial statements of the group in which the entity is consolidated. The Application Guidance to FRS 100 provides guidance on the meaning of equivalence for this purpose.

1.34 There is no requirement for the higher consolidated financial statements to be prepared under any specific GAAP (subject to the general requirement that they are intended to give a true and fair view – see paragraph 1.21 of this publication) and only the basic disclosure requirements of the relevant standard need to be met; compliance with every disclosure requirement of that standard is not required. Disclosure exemptions for qualifying entities are permitted even when the disclosures in the consolidated financial statements are made in aggregate or in an abbreviated form. However, no disclosure exemption is available in the individual financial statements of a qualifying entity (subject to materiality considerations at the entity level) if no disclosure is made in the higher consolidated financial statements on the grounds of materiality from that consolidated point of view. [FRS100.AG8-10]

1.35 The standard itself is silent as to whether disclosure is required in the individual financial statements of material items that are potentially within the scope of the disclosure exemptions but eliminate on consolidation (e.g., intra-group derivatives) and hence are not themselves disclosed in the consolidated financial statements. However, the Application Guidance notes that a disclosure exemption would be available for such items if disclosure is made in the consolidated financial statements in relation to external items of the same nature (in this example, external derivatives).

### Financial institutions

1.36 The question of whether or not an entity is a financial institution, as defined, determines the extent to which it is required to provide disclosures in respect of financial instruments. Thus, a qualifying entity that is a financial institution is not exempt from disclosures in relation to financial instruments under either FRS 101 or FRS 102. In addition, financial institutions reporting under FRS 102 are subject to additional financial instruments disclosures. More specifically:

- FRS 101 adopters: financial institutions reporting under FRS 101 cannot take advantage of the disclosure exemptions from IFRS 7, IFRS 13 (in respect of financial instruments) and the capital management disclosures contained in IAS 1.134-136, that are otherwise available to qualifying entities. [FRS101.7]
- FRS 102 adopters: financial institutions reporting under FRS 102 cannot take advantage of the disclosure exemptions from Sections 11 and 12, even if they are qualifying entities. [FRS102.1.9] In addition, financial institutions must provide additional financial instruments disclosures under Section 34 of FRS 102. See Chapter 34E of this publication for retirement benefit plans and Chapter 34D for other financial institutions.

### Definition of financial institution

1.37 FRS 101 and FRS 102 both define a financial institution as follows: [FRS101.GL, FRS102.GL]

- (a) a bank that is:
- i. a firm with a Part IV permission<sup>10</sup> that includes accepting deposits and:
    - that is a credit institution; or
    - whose Part IV permission includes a requirement that it complies with the rules in the General Prudential sourcebook and the Prudential sourcebook for Banks, Building Societies and Investment Firms relating to banks, but which is not a building society, a friendly society or a credit union;
  - ii. an EEA bank that is a full credit institution;
- (b) a building society that is defined in section 119(1) of the Building Societies Act 1986 as a building society incorporated (or deemed to be incorporated) under that Act;
- (c) a credit union, being a body corporate registered under the Industrial and Provident Societies Act 1965 as a credit union in accordance with the Credit Unions Act 1979, that is an authorised person;
- (d) a custodian bank, broker-dealer or stockbroker;
- (e) an entity that undertakes the business of effecting or carrying out insurance contracts, including general and life assurance entities;
- (f) an incorporated friendly society incorporated under the Friendly Societies Act 1992 or a registered friendly society registered under section 7(1)(a) of the Friendly Societies Act 1974 or any enactment that it replaced, including any registered branches;
- (g) an investment trust, Irish Investment Company, venture capital trust, mutual fund, exchange traded fund, unit trust, open-ended investment company (OEIC);
- (h) a retirement benefit plan; or
- (i) any other entity whose principal activity is to generate wealth or manage risk through financial instruments. This is intended to cover entities that have business activities similar to those listed above but are not specifically included in the list above.

10. As defined in section 40(4) of the Financial Services and Markets Act 2000.



1.38 Thus, rather than providing a brief definition of a financial institution, the FRC has chosen to draw up a list of entities that fall under that term and should therefore give the relevant financial instruments disclosures. The final item (i) was included on the list with the stated aim of capturing any other entities similar to those listed under the preceding categories. [FRS102.ACA.37]

1.39 In practice, judgement is required when determining whether an entity has activities similar to those specifically listed in parts (a) to (h) of the definition. For example, item (d) states that stockbrokers are financial institutions. This term is generally understood to refer to entities that buy and sell securities (including debt, equity and derivatives) on behalf of their clients in return for a fee or commission. The question then arises of how widely or narrowly the reference to ‘similar activities’ should be drawn in the context of stockbrokers. One approach would be to consider entities as having ‘activities similar to those of a stockbroker’ if they buy or sell financial instruments (within the scope of the relevant financial instruments standard) on an agency basis, but to exclude those entities that buy or sell non-financial assets (e.g. works of art) on behalf of their customers.

1.40 FRS 101 and FRS 102 offer only limited guidance to help with the interpretation of paragraph (i). Firstly, a footnote below the definition clarifies that a parent entity whose sole activity is to hold investments in other group entities is not a financial institution. [FRS101.GL, FRS102.GL] In our view, this exemption applies both to direct and indirect parent entities. However, in each case, the entity would need to assess whether it also carries out any other business that might fall under parts (a) to (i) of the definition.

1.41 Secondly, the Accounting Council’s advice on adoption of FRS 102 states that ‘a subsidiary entity engaged solely in treasury activities for the group as a whole is likely to meet the definition of a financial institution’. [FRS102.ACA.37]

1.42 Notwithstanding these additional clarifications, the practical application of the definition requires considerable judgement in some scenarios. It is therefore possible that we will see some diversity in practice in this area.

#### Applying paragraph (i) in practice

1.43 When considering paragraph (i) of the definition, as a first step, an entity should determine its principal activity. For example, a company which manufactures and sells furniture has taken out some derivatives to hedge foreign exchange risk. This company is not a financial institution, given that the management of foreign exchange risk through financial instruments does not represent its principal activity.

1.44 Paragraph (i) makes no distinction whether the entity in question is regulated or not.

1.45 In our view, the legal form of the financial instruments referred to in paragraph (i) is irrelevant. For example, finance leases meet the definition of a financial instrument, even though they are outside the scope of most Section 11 and 12 provisions. Accordingly, a lessor whose principal activity consists of granting finance leases meets the definition of financial institution. On the other hand, operating leases are executory contracts and, in our view, do not meet the definition of financial instruments.

1.46 Paragraph (i) includes the concept of ‘generating wealth’ through financial instruments. One interpretation here would be that the reference relates to financial instruments included in the entity’s own balance sheet, even though we note that this interpretation would then highlight an internal inconsistency in the definition of ‘financial institution’ since stockbrokers do not typically include the brokered securities in their own financial statements.

1.47 We believe that it is irrelevant to the paragraph (i) analysis who the beneficiary of the ‘wealth generation’ is. For example:

- a company holding a portfolio of equity investments generates wealth for its shareholders;
- a defined benefit pension fund uses financial instruments to generate wealth for the pension fund members.

1.48 In both of these examples, the entity’s principal activity is to generate wealth through financial instruments. This can be contrasted with an Employee Benefit Trust (EBT) whose sole activity is to hold treasury shares as directed by the sponsor of the scheme. Rather than generating wealth through financial instruments, the EBT’s principal activity is to hold investments in shares on behalf of the sponsor due to legal restrictions on the holding of own shares.

### Materiality considerations

1.49 In our view, materiality considerations should be taken into account when an entity engages in a number of different activities.

1.50 Consider the example of an investment manager. When the investment manager's activities are limited to managing its clients' investments for a commission, it seems clear that the entity is not a financial institution since the investments it manages (and through which it generates wealth for its clients) are not included in its own financial statements. On the other hand, if the investment manager also holds investments for its own account, then judgement needs to be applied to determine its principal activity.

### Group scenarios

1.51 In our experience, users find it particularly difficult to apply part (i) of the definition in group scenarios, when entities frequently enter into transactions on behalf of other group entities. In our view, in a group scenario, each entity should be assessed on a stand-alone basis. Looking at some common situations:

- A group treasury company enters into derivatives with other group entities and offsets the resulting risk by entering into derivatives with external counterparties. In this case it seems clear that the group treasury company has a principal activity of 'managing risk through financial instruments' and therefore meets the definition of a financial institution.
- A subsidiary's principal activity is to borrow funds externally and lend these onwards to other group entities. On a strict reading of paragraph (i), an entity whose principal activity is to provide finance – whether to external customers or to other group companies – generally meets the definition of a financial institution. The only potential exemption might be when a group company borrows externally and merely passes through to other group companies whatever funding and rate it obtains. However, if the subsidiary is exposed to credit risk, liquidity risk, interest rate risk or similar financial risk and there is therefore potential for a margin or other profit or loss to be generated through financial instruments, we believe that the entity should be viewed as generating wealth through financial instruments.
- A Special Purpose Entity (SPE) in a securitisation structure has a portfolio of mortgage assets, funded through the issue of loan notes to external investors. Even though the SPE primarily holds financial assets on its balance sheet, it passes on all cash collections to the holders of the loan notes. It is less clear in this case that such an entity has a principal activity of generating wealth or managing risk through financial instruments.

### Focus on users of financial statements

1.52 Whilst it is difficult to establish a general principle here, it seems that the FRC's intention was to require financial instruments disclosures for any entities for which financial instruments are central to the business model. [FRS102.ACA.34] Indeed, for such entities, the main purpose of financial instruments disclosures – namely, to enable users of the financial statements to assess (i) the significance of financial instruments to the entity's overall financial position and performance; and (ii) the nature and extent of risks arising from financial instruments and how the entity deals with them – seems particularly relevant to an overall understanding of the financial statements. Whenever it is not immediately clear whether an entity meets the definition of a financial institution, we believe that paragraph (i) should be read in the above light.





# 02 Reduced disclosure framework

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## OVERVIEW OF REQUIREMENTS

- FRS 101 sets out the disclosure exemptions available in the individual financial statements of qualifying entities within a group that otherwise apply the requirements of EU-IFRS (as modified by FRS 101 in order to comply with the Companies Act).
  - A qualifying entity is a member of a group of which the parent prepares publicly available consolidated financial statements that are intended to give a true and fair view and that member is included in the consolidation.
  - FRS 101 cannot be applied in any consolidated financial statements.
  - Financial statements prepared under FRS 101 are Companies Act accounts; certain amendments to the requirements of EU-IFRS (including the use of Companies Act formats, though with some flexibility from 1 January 2016) are therefore required to ensure compliance with the Companies Act.
  - Qualifying entities that are financial institutions are not exempt from the financial instrument disclosure requirements of IFRS 7 and IFRS 13.
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2.1 FRS 101 sets out the disclosure exemptions available in the individual financial statements of qualifying entities within a group that otherwise apply the requirements of EU-IFRS (as modified by FRS 101). A qualifying entity is a member of a group of which the parent prepares publicly available consolidated financial statements that are intended to give a true and fair view and that member is included in the consolidation. The definition of a qualifying entity and the general criteria for applying a reduced disclosure framework as set out in FRS 101 are discussed in paragraphs 1.23 to 1.31 of this publication.

2.2 Qualifying entities that are required or choose to prepare consolidated financial statements may not apply FRS 101 in those financial statements. [FRS101.3]

2.3 Entities applying FRS 101 make a statement of compliance with that standard in the notes to the financial statements. It is not appropriate to include a statement of compliance as set out in IAS 1.16 since the financial statements will not comply with all of the requirements of EU-IFRS.

2.4 The FRC intends to review FRS 101 annually, principally to reflect developments in EU-IFRS. The 2013/14 Cycle of amendments was issued in July 2014, to reflect the IASB's Investment Entities amendment to IFRS 10, IFRS 12 and IAS 27 and amendments to impairment disclosures under IAS 36, as well as editorial amendments to clarify the legal requirements applicable to companies applying FRS 101 that hold financial instruments at fair value. The 2014/15 Cycle of amendments was issued in July 2015, the most significant amendment being to provide an exemption from the presentation of an opening balance sheet on first-time adoption of FRS 101 (see paragraph 2.15 below). This change is effective for periods beginning on or after 1 January 2015. The July 2015 amendments also gave FRS 101 adopters the flexibility to present the profit and loss account and balance sheet using IAS 1 presentation requirements (subject to the amendment to the presentation of discontinued operations discussed in paragraph 2.5 below) rather than the Companies Act formats. This change, as well as other amendments to FRS 101 to reflect changes to the Companies Act following implementation of the new EU Accounting Directive, is effective for periods beginning on or after 1 January 2016. Early-adoption is permitted subject to early-adoption also of the related legal changes (see paragraph INT.7 of this publication).

### Amendments to EU-IFRS requirements

2.5 As financial statements prepared under FRS 101 are Companies Act accounts (see paragraph 1.7 of this publication), certain amendments to the requirements of EU-IFRS are required in order to comply with the Companies Act. [FRS101.5(b)] These are discussed in the Application Guidance to the standard and include:

- The presentation formats of the Companies Act apply rather than those of IAS 1. The requirements of IAS 1 may be applied to the extent that they do not conflict with the Companies Act requirements. The July 2015 revisions to the standard amend this requirement (see paragraph 2.4 above).
- The true and fair override is applied in relation to the non-amortisation of goodwill.
- Negative goodwill is not recognised immediately in profit or loss. It is instead carried on the balance sheet and recognised in profit or loss generally in the same period(s) as the non-monetary assets acquired are recovered.
- Contingent consideration in a business combination is accounted for at its estimated amount when payment is considered probable and the amount can be measured reliably, rather than being included at its fair value at the acquisition date. Changes in contingent consideration are recognised as an adjustment to the acquisition cost rather than being recognised in profit or loss. The July 2015 revisions to the standard remove this amendment to EU-IFRS for contingent consideration balances arising from business combinations with acquisition dates in periods beginning on or after 1 January 2016<sup>1</sup>.
- The analysis of the results of discontinued operations is presented in a columnar format on the face of the statement of comprehensive income, together with a total column.
- Only realised profits may be recognised in profit or loss. However, movements in the value of financial instruments, investment properties and living animals or plants may nevertheless be recognised in profit or loss.
- Government grants related to assets are presented as deferred income and may not be credited to the cost of the related asset. Income from government grants is presented as income in profit or loss and may not be netted against the related expense.

1. Or periods following early-adoption as discussed in paragraph 2.4 of this publication.

- An impairment of goodwill is reversed if (and only if) the reasons for the impairment have ceased to apply. The July 2015 revisions to the standard remove this amendment to EU-IFRS for periods beginning on or after 1 January 2016<sup>2</sup>, meaning that impairments of goodwill will not be reversible in any circumstances.
- A parent that is an investment entity accounts for many or all of its subsidiaries at fair value through profit or loss in its group financial statements, rather than by consolidating them. Those accounted for at fair value through profit or loss are recorded on the same basis in its individual financial statements. Additional disclosures are therefore required under the Regulations. These may be met by giving the corresponding disclosures required by IFRS 7. [FRS101.A2.17-20]
- For periods beginning on or after 1 January 2016<sup>3</sup>, the standard sets out the minimum alternative disclosures that must be given when the 'seriously prejudicial' exemption is applied in respect of the disclosure of provisions, contingent assets or contingent liabilities under IAS 37.

2.6 Entities that are not companies make the same amendments to the requirements of EU-IFRS if applying FRS 101. [FRS101.5(b)]

### Disclosure exemptions

2.7 Qualifying entities may take advantage of some or all of the disclosure exemptions discussed below.

2.8 Under FRS 101 there is no requirement to: [FRS101.8]

- Present comparative movement tables in relation to share numbers, property, plant and equipment, intangible assets, investment properties and biological assets (IASs 1, 16, 38, 40, 41).
- Present a statement of cash flows (IAS 1 and IAS 7).
- Disclose key management personnel compensation (IAS 24). However, for companies, disclosure of directors' remuneration is required under the Companies Act (see paragraph 1.11 of this publication).
- Disclose related party transactions between wholly-owned subsidiaries and parents within a group (the same exemption applies under FRS 102 – see paragraph 33.21 of this publication) (IAS 24). This exemption does not extend to balances with group related parties that are required to be disclosed under the Companies Act.
- Present a third balance sheet when restating comparative information (IAS 1). See paragraph 2.15 below in respect of the requirement to present a third balance sheet on transition to FRS 101.
- Disclose information in relation to new standards not yet applied (IAS 8).
- Give capital management disclosures (IAS 1) (although see paragraph 2.11(b) of this publication).

2.9 Although FRS 101 does not provide any disclosure exemptions in relation to defined benefit pension plans, it is worth noting that IAS 19.150 permits certain information to be disclosed by cross-reference to disclosures in another group entity's financial statements if those financial statements:

- separately identify and disclose the information required about the plan; and
- are available to users of the entity's financial statements on the same terms and at the same time as, or earlier than, the financial statements of the entity.

2.10 In addition, exemption from the following disclosure requirements is available, provided that equivalent disclosures are included in the consolidated financial statements. [FRS101.8] Equivalence for this purpose is discussed in the Application Guidance to FRS 100 (see paragraphs 1.33 to 1.35 of this publication).

- Detailed disclosures in relation to certain group share-based payment arrangements (IFRS 2). This exemption does not include: for a subsidiary, arrangements over its own equity instruments; or for an ultimate parent, arrangements that are not over its own equity instruments.
- Detailed disclosures in relation to business combinations, including current and comparative period movement tables in relation to goodwill (IFRS 3). However, movements in goodwill balances are nevertheless required to be disclosed under the Companies Act.
- Cash flow disclosures in relation to discontinued operations (IFRS 5).

2. Early-adoption will be permitted as discussed in paragraph 2.4 of this publication.

3. Early-adoption is permitted as discussed in paragraph 2.4 of this publication.

- Disclosures in relation to the key assumptions (including sensitivities) and valuation technique used in the determination of recoverable amount for impairment purposes (IAS 36).
- Financial instrument disclosures (IFRS 7) (although see paragraph 2.11 of this publication).
- Disclosures in relation to fair value measurement (IFRS 13) (although see paragraph 2.11 of this publication).

2.11 However, an exemption from financial instrument disclosures is not available in the following cases:

- Entities that are subject to the requirements of the Companies Act and Regulations are legally required to provide disclosures related to financial instruments measured at fair value. Such entities are required by the Companies Act to give the relevant disclosures required by the version of either IAS 32 or IFRS 7 as adopted in the EU on or before 5 September 2004<sup>4</sup>. However, Appendix II of FRS 101 states that the application of the current version of IFRS 7 will meet this requirement. Further guidance is included in Appendix II to FRS 101. Paragraph 55 of Schedule 1 to the Regulations sets out additional disclosure requirements relating to financial instruments measured at fair value. [FRS101.A2.5A-7D]
- Qualifying entities that are financial institutions (see paragraph 1.36 of this publication) cannot apply the disclosure exemptions from either IFRS 7, IFRS 13 (to the extent that they apply to financial instruments), or the capital management disclosures of IAS 1. [FRS101.7]

### Effective date and transitional arrangements

2.12 FRS 101 is applicable for periods beginning on or after 1 January 2015. Early-adoption is permitted. However, early-adoption may be restricted to periods ending on or after 1 October 2012 for companies that previously applied EU-IFRS in their individual financial statements (see paragraph 1.10 of this publication).

2.13 The transitional requirements on adoption of FRS 101 are set out in FRS 100. The date of transition is the start of the earliest comparative period presented in the first financial statements prepared under FRS 101. [FRS101.GL]

2.14 A qualifying entity that did not previously apply EU-IFRS prior to the date of transition applies the requirements of IFRS 1.6 to 1.33 as adopted by the EU, including the relevant appendices (as amended by FRS 101.AG1, that requires a qualifying entity to measure its assets and liabilities in accordance with FRS 101). [FRS100.11(b)]

2.15 A qualifying entity transitioning to FRS 101 that applied EU-IFRS prior to the date of transition considers whether amendments are required to comply with the amendments to EU-IFRS set out in FRS 101.AG1, but does not reapply the provisions of IFRS 1. When amendments to the recognition, measurement or disclosure requirements of EU-IFRS in accordance with paragraph 5(b) of FRS 101 are required, the entity considers whether the amendments have a material effect on the first financial statements prepared under FRS 101. If there is no material effect, the entity discloses that FRS 101 has been adopted and provides a narrative summary of the disclosure exemptions applied. If there is a material effect, the entity's first financial statements prepared under FRS 101 include (for each period practicable):

- a description of the nature of each material change in accounting policy;
- reconciliations of equity under EU-IFRS to that under FRS 101 as at the date of transition to FRS 101 and as at the end of the latest period presented in the entity's most recent annual financial statements prepared under EU-IFRS; and
- a reconciliation of profit or loss under EU-IFRS to that under FRS 101 for the latest period presented in the entity's most recent annual financial statements prepared under EU-IFRS. [FRS100.12]

2.16 Following a change to IFRS 1, for periods commencing on or after 1 January 2013 there is currently no exemption under FRS 101 from the requirement under IFRS 1.21 to present three balance sheets on transition (i.e. to present the transition balance sheet as a second comparative to the current and prior year balance sheets). For earlier periods, the exemption from presenting a third balance sheet discussed in paragraph 2.8 above was available also on transition. The July 2015 amendments to FRS 101 reintroduce this exemption for periods beginning on or after 1 January 2015, with early-adoption permitted.

2.17 Unlike under FRS 102 (see paragraph 35.36 of this publication), there is no transition exemption for dormant companies that apply FRS 101 not to change their accounting until a new transaction occurs. However, as both FRS 101 and FRS 102 give rise to 'Companies Act accounts', dormant companies within an otherwise FRS 101 group could instead apply FRS 102 without breaching the Companies Act consistency requirement and leave their accounting unchanged until there is a new transaction.

4. Date limitation removed July 2015.

# 03 Scope, concepts, principles and presentation

## OVERVIEW OF REQUIREMENTS

- Entities, including public benefit entities, preparing financial statements intended to give a true and fair view apply FRS 102 when they are not eligible or required to apply another reporting framework (e.g. EU-IFRS, FRS 101 or FRSSE) or are eligible but choose not to do so.
- A statement of compliance with FRS 102 and, if applicable, that the entity is a public benefit entity, is given in the notes.
- Departures from FRS 102 or applicable legislation, and the reasons therefor, are disclosed.
- If relevant an entity applies IAS 33, IFRS 6, IFRS 8 and FRS 103 in addition to FRS 102.
- Certain disclosure exemptions are available for qualifying entities.
- The objective of financial statements is to provide relevant financial information to users to inform their economic decisions.
- Financial statements comprise statements (and related notes) showing the financial position, financial performance and cash flows of an entity.
- Financial statements are understandable, relevant, reliable, prudent, complete, comparable and timely. They reflect substance, not merely legal form, and are free from bias.
- Items are recognised in an entity's financial statements when they meet the definition of an asset, liability, income or expense, can be measured reliably and have a probable future economic benefit inflow or outflow.
- Performance is presented in a single statement of comprehensive income or a separate income statement and statement of comprehensive income.
- Income and expenses are recognised as a result of changes in recognised assets and liabilities.
- FRS 102 specifies the bases of measurement for assets, liabilities, income and expenses e.g. historical cost or fair value.
- Financial statements, except cash flow information, are prepared on an accruals basis.
- Offsetting of assets and liabilities or of income and expenses is not allowed unless required or permitted by FRS 102.
- Going concern is assessed by management for at least twelve months. In practice this look-forward period will be twelve months from the date of approval of the financial statements due to auditing standard requirements.
- Any material uncertainties over use of the going concern basis of preparation or a non-going concern basis of preparation are disclosed. Financial statements are usually prepared annually and on a consistent basis. Comparatives are disclosed except when FRS 102 permits or requires otherwise.
- Material items are disclosed separately and materiality is considered in the financial statements aggregation process.
- Financial statements state the entity's name, period end date, presentational currency, rounding level and whether they are group or company financial statements. They also disclose the registered office, country of incorporation and principal activities and operations.

## FRS 102

### Section 3

#### Scope

3.1 FRS 102 applies to financial statements intended to give a true and fair view of a reporting entity's financial position and profit or loss. See Chapters INT, 1 and 2 of this publication for the scope and background to FRSs 100-103. This applies to both companies and public benefit and other entities. Certain paragraphs within FRS 102 are prefixed with 'PBE' and those apply only to public benefit entities: they are not applied by other types of entity.

3.2 FRS 102 applies for accounting periods beginning on or after 1 January 2015<sup>1</sup>. Early-adoption was permitted for accounting periods ending on or after 31 December 2012, except for public benefit entities, for which early-adoption was permitted only if it did not conflict with either the legal requirements for the preparation of the financial statements or the requirements of a current SORP. [FRS102.1.14] Disclosure is required when FRS 102 is early-adopted.

3.3 An entity that applies FRS 102 may also be required to apply the following EU-IFRSs:

- earnings per share: IAS 33 [FRS102.1.4]; and
- segmental information: IFRS 8. [FRS102.1.5]

An entity is required to apply IAS 33 and IFRS 8 if its shares are publicly traded or if it files, or is in the process of filing, financial statements with a regulatory body for a public share issue.

3.4 An entity applies FRS 103 if it issues insurance contracts or financial instruments with a discretionary participation feature; see Chapter 36 of this publication. [FRS102.1.6] There is no requirement to apply IFRS 4.

3.5 An entity that applies FRS 102 that is engaged in the exploration for and/or evaluation of mineral resources (extractive activities) also is required to apply the requirements of IFRS 6. [FRS102.34.11]

3.6 FRS 102 does not cover the presentation of interim financial reports and if such information is presented, then disclosure is made of the basis for preparing and presenting the information. [FRS102.3.25] Instead, when an entity is required to prepare an interim financial report under UK GAAP, FRS 104 is applied.

#### Reduced disclosures for qualifying group entities

3.7 The definition of a qualifying entity is discussed in paragraphs 1.24 to 1.29 of this publication.

3.8 Qualifying entities applying FRS 102 may apply the following disclosure exemptions in their individual accounts, provided they meet the criteria discussed in paragraph 1.30 of this publication. The exemptions may not be applied in any consolidated accounts. [FRS102.1.12]

- (a) Statement of financial position – reconciliation of number of shares outstanding – FRS 102.4.12(a)(iv).
- (b) Presentation of a cash flow statement – Section 7 *Statement of cash flows* and FRS 102.3.17(d).
- (c) Share-based payments – FRS 102.26.18(b), FRS 102.26.19-21 and FRS 102.26.23 except for a group arrangement involving equity instruments of a subsidiary.
- (d) Disclosure of key management personnel compensation – FRS 102.33.7.
- (e) Financial instruments – FRS 102.11.39-48A and FRS 102.12.26-29A except that:
  - i. qualifying entities that are financial institutions (see paragraph 1.36 of this publication) may not apply this exemption. Note that, in addition to the disclosure requirements of Section 11 *Basic financial instruments* and Section 12 *Other financial instruments issues*, such entities give further financial instrument disclosures as set out in Section 34 *Specialised activities* and Chapter 34D of this publication;
  - ii. qualifying entities with financial liabilities held at fair value apply the disclosure requirements of FRS 102.11.48A. However, for financial liabilities held at fair value that are part of a trading portfolio or are derivatives they can take advantage of the exemption in FRS 102.1.12(c).

3.9 The exemptions listed in paragraphs 3.8(c) and (e) of this publication are dependent on the inclusion of equivalent disclosures in the consolidated financial statements of the group in which the entity is consolidated. The application guidance to FRS 100 includes further detail on equivalence. See paragraphs 1.33 to 1.35 of this publication.

1. Certain amendments to the standard, issued in July 2015 as a result of the implementation of the EU Accounting Directive, are effective for periods beginning on or after 1 January 2016, with early-adoption permitted or required in certain instances. See paragraph INT.6 of this publication.



## Concepts and pervasive principles

3.10 FRS 102 sets out the concepts and pervasive principles that entities consider when preparing their financial statements, although it goes on to note that when there are specific requirements within FRS 102 that conflict with these principles, then the specific requirements apply.

3.11 The objective of financial statements is to provide information on the financial position, performance and cash flows of the entity that is useful to a broad range of users in making economic decisions. [FRS102.2.2] They also enable management's stewardship of the company to be assessed. [FRS102.2.3]

3.12 Financial statements need to be understandable to users with a reasonable knowledge of business, economic activities and accounting and a willingness to study the information. However, relevant information may not be omitted on the grounds that it may not be understood by some users. [FRS102.2.4]

3.13 The information included in the financial statements needs to be relevant to users' needs. Information is relevant when it might influence the economic decisions of users by helping them to evaluate past, present or future events. [FRS102.2.5]

3.14 If the omission or misstatement of a piece of information, either on its own or with others, could influence the economic decisions of the users, that information is material, and therefore relevant. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. However, it is inappropriate to make, or leave uncorrected, immaterial departures from FRS 102 in order to achieve a certain presentation in the financial statements. [FRS102.2.6]

3.15 Financial statements provide reliable information that is free from material error or bias, and faithfully represent all information that users could reasonably expect, or that the financial statements claim to include. If, in the selection and presentation of information, there is an intention to influence users' judgement or decision-making in a particular way, the financial statements are not free from bias. [FRS102.2.7]

3.16 To enhance the reliability of financial statements, transactions are presented according to their substance and not just their legal form. [FRS102.2.8]

3.17 When uncertainties exist around events and conditions, appropriate disclosure is made and prudence is exercised in relation to those uncertainties in preparing the financial statements. When exercising judgement around estimates resulting from conditions of uncertainty, prudence is the inclusion of a degree of caution such that expenses and liabilities are not understated and assets and income are not overstated. However, the deliberate overstatement of liabilities and expenses or understatement of assets and income is not permitted; prudence does not permit bias. [FRS102.2.9]

3.18 Financial statements must be complete, while considering materiality and cost. Information may become unreliable or no longer relevant if an omission causes that information to be false or misleading. [FRS102.2.10]

3.19 Users of the financial statements should be able to compare an entity's financial information both over time and to that of other entities so that they are able to evaluate the entity's relative financial performance and position. Therefore, measurement and presentation of financial information should be on a consistent basis both for the entity over time and compared to other entities. The accounting policies used in preparation of the financial statements and any changes therein are disclosed to allow users to understand and compare financial statements. [FRS102.2.11]

3.20 Undue delay in the reporting of financial information may mean it loses relevance to influence the economic decisions of users and such information is therefore provided to users with a degree of timeliness. Management may need to balance the need for timeliness, relevance and reliability of financial information when considering how best to satisfy the needs of users. [FRS102.2.12]

3.21 The cost of providing information should not exceed the benefits of that information. Judgement is required in evaluating the benefits and costs involved: the benefits may accrue to a broad range of users, and the costs may not be borne by those same users. [FRS102.2.13] A lower cost of capital may be enjoyed by the economy as a whole if financial reporting information enables capital providers to make better decisions. Individual entities may also enjoy better access to capital markets, a lower cost of capital, improved public relations, or better management decisions as a result of financial reporting. [FRS102.2.14]



## Financial position

3.22 The relationship on a specific date between an entity's assets, liabilities and equity as presented in the statement of financial position (balance sheet) is its financial position. An asset is defined as a resource from which future economic benefits are expected to flow as a result of control obtained from a past event. A liability is a present obligation arising from past events that is expected to be settled via an outflow of economic benefits. The residual interest in the entity's assets after deducting all liabilities is equity. [FRS102.2.15]

3.23 Some items may meet the definition of an asset or liability but are not recognised in the financial statements as they do not meet the recognition criteria discussed in paragraphs 3.31 to 3.40 of this publication. [FRS102.2.16]

3.24 An asset's potential, directly or indirectly, to contribute to the flow of cash and cash equivalents to the entity is its future economic benefit. The cash flows may be through use or disposal. [FRS102.2.17] An asset may or may not have physical form; some assets are intangible. [FRS102.2.18] The existence of an asset does not rely on a right of ownership, but more on the ability to control the expected future economic benefits. [FRS102.2.19]

3.25 Liabilities oblige an entity to act or perform in a particular manner by way of a present obligation that may be either legal or constructive. A legal obligation is enforceable by law and results from contractual or statutory requirements. A constructive obligation arises from the entity's actions, either from an established pattern of past practices, published policies or a current specific statement that indicates to others that the entity will accept certain responsibilities, such that a valid expectation has been raised in those other parties that the entity will fulfil those responsibilities. [FRS102.2.20]

3.26 A present obligation is normally settled through payment of cash, transfer of other assets, provision of services, the replacement with another obligation or conversion to equity. It is also possible to extinguish an obligation through the counterparty waiving or forfeiting its rights. [FRS102.2.21]

3.27 The residual interest in the entity's assets after deducting all its liabilities is equity. Within the balance sheet, equity may be sub-classified to include, for example, shareholder contributions and retained earnings. [FRS102.2.22]

## Performance

3.28 The relationship between income and expense in a reporting period is an entity's performance. It is presented either in a single statement of comprehensive income or in two statements: an income statement and a statement of comprehensive income. [FRS102.2.23]

3.29 Income is defined as increases in economic benefits in the reporting period as a result of inflows or enhancements of assets or decreases in liabilities that result in increases in equity. When the inflow relates to a contribution from equity investors, this is not income. [FRS102.2.23(a)] Income includes both revenue that arises as part of the ordinary activities of the entity (e.g. sales, fees, interest, royalties, dividends and rent), and gains, which are items other than revenue that meet the definition of income (e.g. the gain on sale of an item of property, plant and equipment (PP&E)). Gains are often presented separately in the statement of comprehensive income to aid users' understanding. [FRS102.2.25]

3.30 Expenses are decreases in economic benefits in the reporting period as a result of asset outflows or additional liabilities incurred that decrease equity. Distributions to equity investors are not expenses. [FRS102.2.23(b)] Expenses include both amounts that arise in the course of the entity's ordinary activities (e.g. cost of sales, wages and depreciation) that result in an outflow or depletion of assets, and losses, that are other items that meet the definition of expenses and that may arise in the ordinary course of business (e.g. the loss on sale of an item of PP&E). Losses are often presented separately in the statement of comprehensive income to aid users' understanding. [FRS102.2.26]

## Recognition of assets, liabilities, income and expenses

3.31 An asset is recognised in the balance sheet when it is controlled by the entity, the flow of future economic benefits is probable and its cost or value can be measured reliably. An asset is not recognised in respect of expenditure when the associated future economic benefits are all expected to be received in the current reporting period. In this case the amount is reported as an expense in the statement of comprehensive income or income statement. [FRS102.2.37]

3.32 A liability is recognised in the balance sheet when it is an obligation as a result of a past event, the settlement amount can be measured reliably and the transfer of economic benefits in settlement is probable. [FRS102.2.39]

3.33 To assess whether the flow of economic benefits is probable, the evidence available when the financial statements are prepared that relates to the conditions at the end of the reporting period is assessed. The assessment is either made individually or for a group of items, depending on their significance. [FRS102.2.29]

3.34 The cost or value of an item is often known or a reasonable estimate can be made. If a reasonable estimate cannot be made the item is not recognised in the financial statements. [FRS102.2.30] An unrecognised item may qualify for recognition at a later date if events and circumstances change. [FRS102.2.31] It may also warrant disclosure in the notes to the financial statements when it is relevant to the evaluation of performance or financial position by users of the financial statements. [FRS102.2.32]

3.35 The recognition of income and expenses results directly from the recognition and measurement of assets and liabilities. Income/expense is recognised in the statement of comprehensive income (or income statement) when an increase/decrease in future economic benefit has arisen as a result of an increase/decrease in an asset or decrease/increase in a liability that can be measured reliably. [FRS102.2.24, FRS102.2.41-42]

3.36 The arithmetic difference between income and expenses is total comprehensive income. [FRS102.2.43] Profit or loss is the arithmetic difference between income and expenses other than income or expenses classified under FRS 102 as other comprehensive income. [FRS102.2.44] See paragraph 5.3 of this publication.

3.37 Disclosure of the accounting policies used or additional explanatory material in the notes does not rectify failure to recognise an item that meets the criteria. [FRS102.2.28]

3.38 Assets and liabilities that do not meet the recognition criteria are not recognised in the balance sheet regardless of applying the so-called 'matching concept' to items in profit or loss. The 'matching concept' refers to the recognition in the same period of all gains and losses relating to the same overall transaction or event. [FRS102.2.45]

3.39 Contingent assets are not recognised in the financial statements. However, when the flow of economic benefits associated with a contingent asset becomes virtually certain the asset meets the asset recognition criteria and is recognised. [FRS102.2.38]

3.40 A contingent liability is either a present obligation that does not meet the recognition criteria of a liability or is a possible but uncertain obligation. Contingent liabilities are not recognised unless acquired as part of a business combination. [FRS102.2.40] See paragraph 19.11 of this publication.

### **Measurement of assets, liabilities, income and expenses**

3.41 Assets, liabilities, income and expenses are measured to determine the amount at which they are recognised in the financial statements. FRS 102 specifies the measurement basis to be used for different types of assets, liabilities, income and expenses, including historical cost or fair value. [FRS102.2.33]

3.42 Historical cost, for assets, is the fair value at the date of acquisition of the consideration given to acquire the asset. For liabilities the historical cost is the fair value of the proceeds or assets received in exchange for the obligation at the date of the transaction. However, in some cases the amount of cash or cash equivalents expected to be paid to settle the obligation may be a more appropriate measurement. [FRS102.2.34] Amortised historical cost is the historical cost of the asset or liability less any portion of the historical cost already recognised as an expense or income.

3.43 Fair value is the amount at which an asset could be exchanged, a liability could be settled, or an equity instrument granted could be exchanged between knowledgeable, willing parties in an arm's length transaction. [FRS102.2.34]

3.44 Assets and liabilities are recognised at historical cost on initial recognition unless required by another section of FRS 102 to be recognised on a different measurement basis (e.g. fair value). [FRS102.2.46]

3.45 Subsequent to initial recognition, basic financial assets and liabilities (as defined in Section 11) are recognised at amortised cost less impairment, except for:

- investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares that are publicly traded or whose fair value can otherwise be measured reliably; and
- any financial instrument that upon initial recognition was designated by the entity as at fair value through profit or loss.

3.46 These instruments are measured at fair value with changes in fair value recognised in profit or loss. [FRS102.2.47]

3.47 Other financial assets and liabilities are measured at fair value with changes in fair value recognised in profit or loss, unless FRS 102 requires or permits another measurement basis such as amortised cost. [FRS102.2.48]

3.48 Most non-financial assets are subsequently measured on a different basis from their initial measurement at historical cost, for example the cost model or revaluation model for property, plant and equipment; the lower of cost and selling price less costs to complete and sell for inventories; or the cost or fair value model for investments in associates and joint ventures and agricultural assets. [FRS102.2.49-50]

3.49 Investment property is required to be measured at fair value under FRS 102 when the fair value is readily determinable without undue cost or effort: see Chapter 16 of this publication. [FRS102.2.50]

3.50 Most liabilities other than financial liabilities are subsequently measured at the best estimate of the amount required to settle the obligation at the reporting date. [FRS102.2.51]

### **Pervasive recognition and measurement principles**

3.51 The recognition and measurement criteria set out in FRS 102 are based on the pervasive principles that are derived from the IASB's *Framework for the Preparation and Presentation of Financial Statements* (now called the *Conceptual Framework for Financial Reporting*) and from EU-IFRS. When specific guidance on a transaction or event is not given in FRS 102, the guidance on the judgement and selection of accounting policies in Section 10 *Accounting policies, estimates and errors* is followed (see paragraph 10.2 of this publication). After consideration of specific guidance within FRS 102, the concepts and principles of Section 2 *Concepts and pervasive principles*, discussed in this chapter, are followed. [FRS102.2.35]

### **Accruals basis**

3.52 Except for cash flow information, financial statements are prepared on an accruals basis. As such, items are recognised when they meet the definitions and recognition criteria set out in FRS 102. [FRS102.2.36]

### **Offsetting**

3.53 Assets and liabilities are not offset unless required or permitted by FRS 102. Measuring assets net of a valuation allowance is not offsetting. Also, if buying and selling non-current assets is not part of the entity's normal operating activities, then any gains and losses on disposal of these assets are reported by deducting the carrying amount and any selling expenses from the proceeds of sale. [FRS102.2.52]

### **Fair presentation**

3.54 Financial statements present fairly an entity's financial position, financial performance and, when required to be presented (see paragraphs 7.1 and 7.2 of this publication for when this is not required), cash flows. This requires faithful presentation of all transactions and other events and conditions in accordance with the recognition criteria of Section 2. Application of FRS 102 is presumed to result in a fair presentation of financial statements when coupled with any additional disclosures given when the requirements of FRS 102 are insufficient for users to understand fully the effect of certain transactions. [FRS102.3.2]

3.55 Fair presentation is the same as a 'true and fair view' as required for companies by section 393 of the Companies Act.

3.56 In the notes to the financial statements an explicit statement is made that the financial statements comply with FRS 102 when this is the case. [FRS102.3.3] In addition, a public benefit entity makes an explicit and unreserved statement that it is a public benefit entity when it has applied the 'PBE' prefixed paragraphs. In some extremely rare cases, compliance with FRS 102 or applicable legislation may be so misleading that management believes it conflicts with the objective of the financial statements. [FRS102.3.4] In this case, management departs from the requirements of FRS 102 and makes certain disclosures, including the reasons why the application of the requirements of FRS 102 or applicable legislation would be misleading. This is known as a 'true and fair override'. [FRS102.3.5]

### Going concern

3.57 Management makes an assessment of the entity's ability to continue as a going concern when preparing financial statements. Unless management intends or has no realistic alternative but to liquidate or cease operations of the entity, the entity is a going concern. In making this assessment all relevant information about the future is considered, covering a period of at least twelve months from the date of approval of the financial statements. [FRS102.3.8]

3.58 If material uncertainties exist that cast significant doubt on the entity's ability to continue as a going concern, then those uncertainties are disclosed. [FRS102.3.9]

3.59 The FRC issued guidance about going concern disclosures in financial statements in 2009, *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies*. The FRC is in the process of updating and replacing that guidance. For companies that are subject to the UK Corporate Governance Code, new guidance was issued in September 2014 in its *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*, which first applies for accounting periods beginning on or after 1 October 2014. For other UK companies, the FRC is preparing separate, simpler guidance on which it intends to begin consultation in the near future.

3.60 If the financial statements are not prepared on a going concern basis, then the basis used to prepare the financial statements and the reasons why the entity is not considered to be a going concern are disclosed. [FRS102.3.9]

### Frequency of reporting

3.61 Presentation of a complete set of financial statements is generally required at least annually, although more or less frequent reporting may apply if the entity changes its reporting date. If the period is longer or shorter than one year due to a change in reporting date, that fact is disclosed along with the relevant rationale. The disclosure also states that comparative information may not be entirely comparable. [FRS102.3.10]

### Consistency of presentation

3.62 The presentation and classification of financial statements is consistent year on year unless:

- FRS 102 or another applicable FRS or FRC Abstract requires a change in presentation; or
- a significant change in the nature of the entity's operations or a review of the financial statements indicates that a different presentation would be more appropriate (see Chapter 10 of this publication). [FRS102.3.11]

3.63 Comparative amounts are reclassified when a change in presentation occurs, unless it is impracticable to do so. Disclosure is made of the nature, amount and reason for the reclassification. [FRS102.3.12]

### Comparatives

3.64 Comparative information is always disclosed for the previous reporting period unless FRS 102 permits or requires otherwise. [FRS102.3.14] For example, Section 17 *Property, plant and equipment* does not require the reconciliation of the carrying amount at the beginning and end of the period to be presented for the prior period.

### Materiality and aggregation

3.65 Each material (see paragraph 3.14 of this publication) class of similar items is presented separately. [FRS102.3.15] Transactions are aggregated depending on their nature or function and then classified as line items either in the financial statements or notes, depending on materiality. [FRS102.3.16] Disclosures need not be given if the information is not material. [FRS102.3.16A]

### Complete set of financial statements

3.66 A complete set of financial statements includes a statement of financial position (balance sheet) at the reporting date; either a single statement of comprehensive income for the reporting period or a separate income statement (profit and loss account) and statement of comprehensive income; a statement of changes in equity for the reporting period; a statement of cash flows for the reporting period (when applicable, see Chapter 7 of this publication) and related notes. [FRS102.3.17] On the basis that comparatives are required for the previous reporting period (see paragraph 3.64 of this publication), this effectively means that a complete set of financial statements includes two of each of the above statements and notes.

3.67 If there is no other comprehensive income in the current or comparative periods, the entity may present only an income statement rather than an income statement and a separate statement of comprehensive income. If the only changes to equity in the periods for which the financial statements are presented are from profit or loss, dividends, and correction of prior period errors or changes in accounting policy, a single statement of income and retained earnings may be presented in place of a statement of comprehensive income and statement of changes in equity. [FRS102.3.18]

3.68 Each financial statement (primary statement) is presented with equal prominence. [FRS102.3.21] A different title may be used to those outlined in FRS 102 as long as it is not misleading. [FRS102.3.22] Entities are required to comply with the financial statement formats of FRS 102 and with company (or LLP) law when referred to by FRS 102, except to the extent that these requirements are not permitted by any statutory framework under which such entities report. See Appendix II of this publication for common profit and loss account and balance sheet formats under the Companies Act.

### Identification

3.69 Each of the financial statements and the related notes are distinguished clearly from other information in the same document.

3.70 The reporting entity name and any changes in name in the period, the reporting date and period, the presentation currency, the level of rounding used and whether the financial statements are group or individual are displayed prominently in the financial statements and repeated as necessary to aid understanding. The domicile and legal form of the entity, country of incorporation and registered address are disclosed in the financial statements alongside a description of the nature of the entity's operations and principal activities. [FRS102.3.23-24]

## vs previous UK GAAP

### Applicable standards: ASB Statement of Principles, SSAP 25, FRS 3, FRS 5, FRS 28

pUK3.1 The concepts and principles of the ASB's Statement of Principles are in line with those stated in FRS 102.

pUK3.2 FRS 5 and the Statement of Principles contain specific guidance on how to apply the principle that transactions are accounted for in accordance with their commercial substance rather than simply their legal form. Application Notes to FRS 5 apply that principle to a variety of complex transaction types.

pUK3.3 The following are generally presented as primary statements: profit and loss account; statement of total recognised gains and losses; balance sheet; and (for certain entities) a cash flow statement. See Chapters 4 to 7 of this publication for further guidance.

pUK3.4 More entities are required to provide segmental reporting disclosures under SSAP 25 than under FRS 102, including certain large private entities and unlisted public limited companies. The detailed requirements of SSAP 25 also differ from those of IFRS 8 (which are applied by those required to provide segment information under FRS 102). This includes the possibility of a 'seriously prejudicial' exemption from disclosure that is not available under IFRS 8.

## vs EU-IFRS

### Applicable standards: IASB Framework, IAS 1, IAS 34, IFRS 8, IFRS 13

IFRS3.1 FRS 102 and EU-IFRS are both based on the IASB Framework. However, the Framework contains concepts of capital and capital maintenance that are not defined in FRS 102.

IFRS3.2 Under EU-IFRS, there are fewer exceptions from the presentation of comparative information. For example, movements in property, plant and equipment are also presented for the comparative period.

IFRS3.3 IAS 1 requires an entity to present a statement of financial position as at the beginning of the earliest comparative period (i.e. a third balance sheet) when the entity applies an accounting policy retrospectively or corrects a prior period error, or when it reclassifies items in its financial statements.



# 04 Statement of financial position (Balance sheet)

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## OVERVIEW OF REQUIREMENTS

- The statement of financial position (which may also be called the balance sheet) is presented in accordance with the Companies Act formats. This applies even if the entity is not required to prepare accounts in accordance with the Companies Act (for example an entity that is not a company), unless the applicable legislation does not permit this.
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## FRS 102

### Section 4

- 4.1 The balance sheet is prepared as at an entity's reporting date. [FRS102.4.1]
- 4.2 An entity presents its balance sheet in line with Part 1 General Rules and Formats of either:
- (a) Schedule 1 to the Regulations (applies to all entities other than those applying (b), (c), or (d), unless legislation specific to the entity requires a different format, see paragraph 1.13 of this publication);
  - (b) Schedule 2 to the Regulations (applies to banking entities<sup>1</sup>);
  - (c) Schedule 3 to the Regulations (applies to insurance entities<sup>1</sup>); or
  - (d) Schedule 1 to the LLP Regulations (applies to LLPs).
- 4.3 A group balance sheet is presented in line with Schedule 6 to the Regulations or Schedule 3 to the LLP Regulations. [FRS102.4.2]
- 4.4 Each schedule specifies different formats for the order and terminology for the balance sheet. For example, Schedule 2 allows banks to present their assets in order of liquidity. Appendix II to this publication replicates Format 1 from Schedule 1 to the Regulations.
- 4.5 Additional line items are presented as necessary to aid users' understanding of the entity's financial position. [FRS102.4.3] The Companies Act requires the headings and sub-headings to be adapted when the special nature of the entity's business requires it.
- 4.6 Under the Companies Act, and therefore under FRS 102, creditors are split between amounts due within one year and amounts due after one year. If an entity does not have an unconditional right, at the period end, to defer settlement of a liability for at least twelve months after the reporting date, then that liability is classified as due within one year. [FRS102.4.7]
- 4.7 A lending agreement may include covenants that, if breached, render the related debt repayable before its contractual maturity date. Such an acceleration of required payments may be automatic or may be at the discretion of the lender. A liability that is repayable on demand because loan conditions have been breached is classified as an amount due within one year, even if the lender has agreed, after the reporting date but before the financial statements are authorised for issue, not to demand payment as a consequence of the breach (see paragraph 32.8 of this publication). However, the debt is classified as an amount due after one year if the lender agrees by the reporting date to provide a period of grace ending at least twelve months after the reporting date.
- 4.8 Loan agreements may include objective and/or subjective covenant clauses. Although subjective clauses may require greater judgement, in our view objective and subjective covenant tests should be dealt with consistently because both need to be assessed to determine whether an entity has an unconditional right to defer settlement of the liability. It is necessary to determine whether a covenant breach exists at the reporting date. This may require judgement, and more judgement may be needed to determine whether a subjective clause is breached at the reporting date.
- 4.9 In some circumstances, compliance with a loan covenant is assessed after the reporting date but the related tests for covenant compliance are based on financial information as at or before the reporting date. In our view, any breach of such a covenant that renders the related debt payable within twelve months after the reporting date should be treated as an adjusting subsequent event (see paragraphs 32.2 to 32.3 of this publication) and the related liability should be classified as current at the reporting date.
- 4.10 In our view, covenant tests that are based on information as at a date after the reporting date should be disregarded when assessing the classification of the liability at the reporting date, even when the entity assesses the likelihood of a breach at such future date as probable.
- 4.11 In some circumstances, an entity may - before the reporting date - obtain from a lender an agreement to amend a lending arrangement. Such amendments may defer the date as at which information is assessed for testing covenant compliance from a date at or before the reporting date to a later date. Consistent with our view in paragraph 4.10, we believe that in such situations, whether the entity would have breached the related covenant had the agreement not been amended does not affect the classification of the liability at the reporting date.
- 4.12 Debtors that are due after more than one year are required by the Regulations to be included within current assets (as defined by the Companies Act). Subject to the exception below, if this balance is sufficiently material to the financial statements, it is disclosed on the face of the balance sheet within current assets, otherwise it is disclosed in the notes. [FRS102.4.4A]

1. The definitions of banking and insurance entities are found in the Companies Act sections 1164 and 1165 respectively.

4.13 For accounting periods beginning on or after 1 January 2016<sup>2</sup>, a new paragraph 1A(1) of Schedule 1 to the Regulations is added. Under this new paragraph, a company's directors may adapt one of the balance sheet formats in Section B of Schedule 1 of the Regulations so as to distinguish between current and non-current items in a different way, provided that the information given is at least equivalent to that which would have been required by the use of such a format, had it not been adapted, and the presentation of those items is in accordance with generally accepted accounting principles or practice. In practice, this permits the presentation of a balance sheet more consistent with an IAS 1 format. An entity choosing to apply paragraph 1A(1) of Schedule 1 to the Regulations and adapt one of the balance sheet formats includes the following items as a minimum on the face of the balance sheet, distinguishing between those items that are current and those that are non-current:

- (a) property, plant and equipment;
- (b) investment property carried at fair value through profit or loss;
- (c) intangible assets;
- (d) financial assets (excluding amounts shown under (e), (f), (j) and (k));
- (e) investments in associates;
- (f) investments in jointly controlled entities;
- (g) biological assets carried at cost less accumulated depreciation and impairment;
- (h) biological assets carried at fair value through profit or loss;
- (i) inventories;
- (j) trade and other receivables;
- (k) cash and cash equivalents;
- (l) trade and other payables;
- (m) provisions;
- (n) financial liabilities (excluding amounts shown under (l) and (m));
- (o) liabilities and assets for current tax;
- (p) deferred tax liabilities and deferred tax assets (classified as non-current);
- (q) non-controlling interest, presented within equity separately from the equity attributable to the owners of the parent; and
- (r) equity attributable to the owners of the parent. [FRS 102.4.2A]

FRS 102.4.2B to D include further minimum format requirements when the formats are adapted in this way.

When the formats are adapted, for example by including debtors due in more than one year only in the notes, the requirement (as discussed in paragraph 4.12 of this publication) to disclose sufficiently material debtors that are due after more than one year on the face of the balance sheet within current assets, does not apply. [FRS102.4.4A]

4.14 Other than as strictly required or permitted by FRS 102, amounts in respect of items of income and expense may not be offset. However, in certain circumstances financial assets and financial liabilities may be offset. See paragraph 11.116 of this publication. [FRS102.2.52]

4.15 Details of share capital, including the number of shares in issue, are disclosed either on the face of the balance sheet or in the notes. [FRS102.4.12] Similar information is presented for an entity without share capital, such as a partnership, including the rights and restrictions of each type of equity. [FRS102.4.13]

4.16 If a binding sale agreement for a major disposal of assets, or of a disposal group, is in place at the reporting date, a description of the assets (or disposal group) and details of the facts and circumstances of the sale are disclosed, in addition to the carrying amount of the assets (or disposal group). A disposal group is a group of assets and the liabilities associated with them that will together be sold, transferred or otherwise disposed of in a single transaction. The disposal group includes acquired goodwill allocated to it in line with paragraphs 27.28 to 27.29 of this publication.

2. Early-adoption is permitted as discussed in INT.7 of this publication.

## vs previous UK GAAP

Applicable standards: FRS 2, FRS 25, FRS 28, UITF 4, UITF 24, UITF 34

pUK4.1 Previous UK GAAP also requires the balance sheet to be presented in accordance with the Companies Act schedules so this is not a GAAP difference for companies. For other entities, the Companies Act formats apply under FRS 102 whereas they were not mandated under previous UK GAAP. Appendix IV to FRS 102 details other legal frameworks and the Accounting Council does not believe the formats required by these frameworks are inconsistent with FRS 102.

## vs EU-IFRS

Applicable standards: IAS 1, IAS 8, IFRS 5

IFRS4.1 Assets and liabilities are classified under IAS 1 as either current or non-current based on criteria that include the entity's normal operating cycle and the purpose for which the assets or liabilities held. Those criteria are wider than the twelve months from the balance sheet date criterion of FRS 102.

IFRS4.2 IFRS 5 requires the separate presentation of assets classified as held for sale or assets and liabilities included in a disposal group held for sale either in the statement of financial position or in the notes. FRS 102 contains no definition of held for sale and it is not included in the definition of discontinued operations. FRS 102 requires separate disclosure of the disposal group in the notes only when there is a binding sale agreement, whereas IFRS 5 disclosure and remeasurement is required also when the sale is highly probable.

# 05 Statement of comprehensive income and income statement

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## OVERVIEW OF REQUIREMENTS

- The statement of comprehensive income can be presented either as one or two statements, as a policy choice.
  - Items of income and expenditure within the statement of comprehensive income are presented in accordance with the Companies Act profit and loss account formats. This applies even if the entity is not required to prepare accounts in accordance with the Companies Act (for example an entity that is not a company), unless the applicable legislation does not permit this.
  - Other comprehensive income includes certain foreign exchange gains and losses; actuarial gains and losses; and changes in fair value of hedging instruments (and property, plant and equipment, investments and intangible assets if carried at fair value).
  - The results of discontinued operations are presented separately using a columnar approach.
  - Individually material items are disclosed separately.
  - Extraordinary items are highly abnormal and are not expected to occur in practice. For periods beginning on or after 1 January 2016, items may not be described as extraordinary.
-

## FRS 102

### Section 5

5.1 An entity has a choice whether to present total comprehensive income for the period in one statement (a statement of comprehensive income) or two statements (an income statement, also known as a profit and loss account, and a statement of comprehensive income). [FRS102.5.2] A change from presenting one statement to two (or vice versa) is a change in accounting policy and is accounted for as such. [FRS102.5.3] Accounting policies are discussed in Chapter 10 of this publication.

5.2 In the one-statement approach, all items of income and expense recognised in the period are included in the statement of comprehensive income. Under the two-statement approach, the income statement includes all items of income and expense recognised in the period, other than those recognised outside profit or loss. [FRS102.5.2] Under the Companies Act only realised profits are typically included in profit or loss. Despite this fact, movements in the fair values of financial instruments, investment properties and living animals or plants may be recognised in profit or loss under the Companies Act; entities within the scope of the Companies Act may wish to record such amounts in a separate non-distributable reserve within equity. [FRS102.A4.25-29]

5.3 Items of other comprehensive income (OCI) that are recognised outside profit or loss as part of total comprehensive income include:

- foreign exchange component of a gain or loss on a non-monetary item when the gain or loss itself has been recognised in OCI (for example, any foreign exchange component of actuarial gains and losses or of the revaluation of property, plant and equipment, see below); [FRS102.30.11]
- foreign exchange differences on a net investment in a foreign operation in the financial statements that include the foreign operation and the reporting entity; [FRS102.30.13]
- foreign exchange differences on translating assets, liabilities, income and expenses from a functional currency to the presentational currency; [FRS102.30.18(c)]
- remeasurement of a defined benefit pension liability, i.e. actuarial gains and losses, and the return on plan assets excluding the amount included in net interest; [FRS102.28.23(d), FRS102.28.25]
- the effective portion of the change in the fair value of hedging instruments when the hedged risk is variable interest rate risk, foreign exchange risk or commodity price risk in a firm commitment or highly probably forecast transaction, or (in consolidated financial statements) a net investment in a foreign operation; [FRS102.12.23]
- changes in fair values of investments in subsidiaries, associates and joint ventures when the parent has made the accounting policy election to account for its investments in subsidiaries, associates and joint ventures at fair value with changes in fair value recognised in accordance with paragraphs FRS 102.17.15E and FRS 102.17.15F (see following bullet); [FRS102.9.26(b), FRS102.14.10, FRS102.15.15]
- revaluation increases and decreases when the revaluation model is selected for the measurement of property, plant and equipment, heritage assets or intangible assets; [FRS102.17.15E-F, FRS102.34.49, FRS102.18.18G-H] and
- the movements in fair value of available-for-sale assets when an entity chooses under FRS 102.11.2 to apply IAS 39 for the recognition and measurement of its financial instruments.

#### One-statement approach

5.4 Subject to the exception explained in paragraph 5.9 of this publication below, in its statement of comprehensive income an entity includes the profit and loss account items in line with Part 1 General Rules and Formats of one of the following:

- (a) Schedule 1 to the Regulations (applies to all entities other than those applying (b), (c), or (d), unless legislation specific to the entity requires a different format; see paragraph 1.12 of this publication);
- (b) Schedule 2 to the Regulations (applies to banking entities<sup>1</sup>);
- (c) Schedule 3 to the Regulations (applies to insurance entities<sup>1</sup>);
- (d) Schedule 1 to the LLP Regulations (applies to LLPs). [FRS102.5.5]

5.5 A group profit and loss account is presented in line with Schedule 6 to the Regulations or Schedule 3 to the LLP Regulations. [FRS102.5.5]

1. The definitions of banking and insurance entities are found in the Companies Act sections 1164 and 1165 respectively

5.6 Each Schedule specifies different formats for the order and terminology for the profit and loss account. For example, Format 1 in Schedule 1 to the Regulations presents expenses by function and Format 2 presents them by nature. Appendix II to this publication replicates Formats 1 and 2 from Schedule 1 to the Regulations.

5.7 Under this approach an entity includes in the single statement:

- (a) other than amounts in (b), each item of OCI for the period as per paragraph 5.3 of this publication, analysed by nature and shown either net of tax or before tax with the aggregate tax shown for all components of OCI;
- (b) its share of OCI of associates and jointly controlled entities for the period; and
- (c) total comprehensive income for the period. [FRS102.5.5A]

5.8 Comprehensive income and profit or loss for the period are allocated between any non-controlling interests and the owners of the parent. [FRS102.5.6] In practice this is applicable only to consolidated financial statements.

5.9 For accounting periods beginning on or after 1 January 2016<sup>2</sup> company directors may adapt one of the profit and loss account formats in Schedule 1 provided that the information given is at least equivalent to that which would have been required by the use of such format had it not been adapted, and the presentation of those items is in accordance with generally accepted accounting principles or practice. An entity choosing to apply paragraph 1A(2) of Schedule 1 to the Regulations and adapt one of the profit and loss account formats includes the following items as a minimum on the face of its statement of comprehensive income:

- (a) revenue;
- (b) finance costs;
- (c) share of the profit or loss of investments in associates and jointly controlled entities accounted for using the equity method;
- (d) profit or loss before taxation;
- (e) tax expense excluding tax allocated to items (h) and (i) below or to equity;
- (f) in a column identified as discontinued operations, a single amount comprising the total of:
  - i. the post-tax profit or loss of a discontinued operation, and
  - ii. the post-tax gain or loss recognised on the remeasurement of the impairment or on the disposal of the assets or disposal group(s) constituting discontinued operations.
- (g) profit or loss;
- (h) each item of other comprehensive income classified by nature (excluding amounts in (i));
- (i) share of other comprehensive income of associates and jointly controlled entities accounted for by the equity method; and
- (j) total comprehensive income. [FRS 102.5.5B]

In practice, this will permit the presentation of an income statement more consistent with an IAS 1 format, although note that under FRS 102 the results of discontinued operations are presented in a separate column, rather than as a single line item in the statement of comprehensive income. A total column (of continuing and discontinued operations) is also presented. [FRS102.5.7E]<sup>3</sup>.

### Two-statement approach

5.10 Under the two-statement approach an entity presents the following statements:

- i. an income statement (profit and loss account) in the format described in either paragraphs 5.4 or 5.9 of this publication; [FRS102.5.7] and
- ii. a statement of comprehensive income, which has the profit or loss for the period as its first line and presents the items of OCI for the period as described in paragraph 5.7 of this publication. [FRS102.5.7B]

<sup>2</sup> Early-adoption is permitted as discussed in paragraph INT.7 of this publication.

<sup>3</sup> Revised reference following July 2015 amendments to FRS 102.

5.11 As with the single statement approach, profit or loss for the period and comprehensive income for the period are analysed between that attributable to:

- non-controlling interests; and
- owners of the parent. [FRS102.5.7A-B]

### Requirements applicable under both approaches

#### Discontinued operations

5.12 Discontinued operations are defined as a component of an entity that has been disposed of before the reporting date and that:

- (a) represented a separate major line of business or geographical area of operations;
- (b) was part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
- (c) was a subsidiary acquired exclusively with a view to resale. [FRS102.GL]

5.13 A component of an entity is defined as operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. [FRS102.GL]

5.14 The post-tax profit or loss of a discontinued operation is presented on a line-by-line basis in a separate 'discontinued operations' column on the face of the profit and loss account (or statement of comprehensive income if the one-statement approach is taken). This column will also include the post-tax gain or loss on disposal or impairment of the discontinued operation. This column is given in addition to 'continuing operations' and a 'total' column is also disclosed. An illustration of this is included in the appendix to Section 5. [FRS102.5.7B] Prior period comparatives are similarly presented for all operations discontinued by the end of the current reporting period. [FRS102.5.7D-E]

#### Other requirements applicable under both approaches

5.15 As a minimum the amount of turnover is presented on the face of the profit and loss account (or statement of comprehensive income if the one-statement approach is taken). [FRS102.5.7C]

5.16 The correction of material errors and changes in accounting policy are accounted for as retrospective adjustments to prior periods in accordance with Section 10 *Accounting policies, estimates and errors*. [FRS102.5.8]

5.17 Additional line items, headings and sub-headings are presented when relevant to aid the understanding of the financial statements. [FRS102.5.9] Items included in total comprehensive income are presented separately when material, although FRS 102 does not refer to such items as 'exceptional items'. [FRS102.5.9A] The Companies Act requires the headings and sub-headings to be adapted when the special nature of the entity's business requires it.

5.18 Operating profit is not required to be disclosed. When the results of operating activities **are** disclosed, this represents activities normally considered to be operating. This would include items such as inventory write-downs, restructuring costs and other operating items, even if they occur infrequently. [FRS102.5.9B]

5.19 Ordinary activities are activities that are undertaken as part of an entity's business and related activities. This includes political, regulatory, economic and geographical effects, regardless of the frequency or unusual nature of events. [FRS102.5.10]

5.20 Subject to the exception below, extraordinary items are material transactions or events with a high degree of abnormality that arise outside ordinary activities. They are not expected to recur. Extraordinary items do not include any additional line item, headings or sub-headings presented as a result of paragraph 5.17 of this publication. Extraordinary items are not expected to be seen in practice given that the definition of ordinary activities is very wide. [FRS102.5.10A]

5.21 For accounting periods beginning on or after 1 January 2016 items of income and expense may no longer be presented or described as 'extraordinary items' in the statement of comprehensive income (or in the income statement, if presented) or in the notes. [FRS102.5.10]

5.22 An analysis of expenses is presented based on either their nature or function, whichever is more relevant and reliable for that entity, unless the Regulations require otherwise. The choice between the two analyses often depends

upon the nature of the entity and the industry in which it operates. Classification by nature (as presented in Format 2, see paragraph 5.6 of this publication) involves aggregating expenses according to their nature (e.g. depreciation, staff costs). Analysis by function (as presented in Format 1, see paragraph 5.6 of this publication) involves aggregation of expenses according to their function (e.g. cost of sales, distribution costs, administrative expenses).

5.23 Other than as required or permitted by FRS 102, amounts in respect of items of income and expense may not be offset. [FRS102.2.52]

### Transition

5.24 On first-time adoption of FRS 102, there are two specific exemptions from the general application of FRS 102 that are relevant to this topic.

5.25 The definition of discontinued operations differs between both FRS 102 and previous UK GAAP (FRS 3) and FRS 102 and IFRS 5. However, on transition to FRS 102 an entity is not permitted to change retrospectively the accounting it has followed previously for discontinued operations, and no reclassification or remeasurement from its previous financial reporting framework for discontinued operations is permitted. [FRS102.35.9]

5.26 As mentioned in paragraph 5.8 of this publication, comprehensive income, and profit or loss for the period, are allocated between any non-controlling interests and the owners of the parent. However, this allocation is required to be applied prospectively only from the date of transition to FRS 102, or from an earlier date if the entity decides to restate its business combinations from an earlier date (see paragraph 35.9 of this publication). [FRS102.35.9]



## vs previous UK GAAP

### Applicable standards: FRS 3, FRS 28

pUK5.1 The profit and loss account and statement of total recognised gains and losses (STRGL) cannot be presented as one combined statement under previous UK GAAP. The STRGL presents the total of recognised gains and losses (income and expense) recognised in the period that is attributable to shareholders. This statement includes both the profit or loss recorded in the profit and loss account, and gains and losses recorded elsewhere, such as movements on a revaluation reserve, unrealised foreign exchange translation differences and actuarial gains and losses on defined benefit pension plans. If there are no recognised gains or losses other than the profit or loss for the year, an entity can make a statement to this effect and is not required to present a separate STRGL. The STRGL is broadly equivalent to the statement of comprehensive income when a two-statement approach is taken under FRS 102, except that the amounts included in the STRGL do not include amounts attributable to minority interests (non-controlling interests).

pUK5.2 The definition of discontinued operations under FRS 3 differs from that under FRS 102. It includes not only operations that are sold or terminated in the period, but also those that are sold or terminated before the earlier of three months after the end of the reporting period and the date the financial statements are approved. In addition, under FRS 3, the sale or termination must have a material effect on the nature and focus of the entity's operations, representing a material reduction in operating facilities. For example, an operation disposed of two months after the year end, before the financial statements are approved, would be classified as discontinued under FRS 3 (assuming the other conditions are met). It would not meet the definition under FRS 102 as it had not been disposed of at the year end.

pUK5.3 Under FRS 3, interest and taxation charges/credits are not required to be analysed between continuing and discontinued operations, whereas FRS 102 requires an analysis to be given to the profit after tax level. Only the analysis of turnover, operating profit, and 'paragraph 20' exceptional items (see paragraph pUK5.7 of this publication) is required to be shown on the face of the profit and loss account under FRS 3: the remaining analysis may be included in the notes to the financial statements.

pUK5.4 FRS 3 requires analysis on the face of the profit and loss account of the results of acquisitions in the period.

pUK5.5 FRS 3 requires the presentation of 'operating profit', that is usually profit before income from shares in group undertakings.

pUK5.6 FRS 3 has the concept of 'exceptional items' that are material items resulting from ordinary activities that, due to their size or incidence, require separate disclosure in order for the financial statements to give a true and fair view. Separate disclosure is made on the face of the profit and loss account if that degree of prominence is required for a true and fair view. Otherwise an entity may choose to present exceptional items on the face of the profit and loss account or in the notes.

pUK5.7 Three types of non-operating items (so-called 'paragraph 20' items) are required to be presented outside operating profit or loss: the profit or loss on sale of an operation; fundamental restructuring costs; and the profit or loss on disposal of fixed assets.

pUK5.8 FRS 3 contains a requirement for a note of historical cost profits and losses to be presented when there is a material difference between the result as disclosed in the profit and loss account and the result on an unmodified historical cost basis.

pUK5.9 Under FRS 3 the cumulative effect of prior period adjustments is noted at the foot of the current year STRGL.

pUK5.10 Previous UK GAAP also requires the profit and loss account to be presented in accordance with the Companies Act formats so this is not a GAAP difference for companies. For other entities, the Companies Act formats will now apply under FRS 102: they were not mandated under previous UK GAAP. Appendix IV to FRS 102 details other legal frameworks and the Accounting Council does not believe the formats required by these frameworks are inconsistent with FRS 102.

## vs EU-IFRS

### Applicable standards: IAS 1, IAS 8, IFRS 5

IFRS5.1 Under EU-IFRS there is no definition of an extraordinary item. This classification is not used.

IFRS5.2 For entities applying EU-IFRS there is no prohibition on recognising unrealised profits in the income statement.

IFRS5.3 The definition of a discontinued operation under IFRS 5 includes a component of an entity that is classified as held for sale at the reporting date. This is not included in the FRS 102 definition.

IFRS5.4 Under IFRS 5 the analysis of the results of a discontinued operation may be presented in the notes to the financial statements. Under FRS 102 this is presented on the face of the statement of comprehensive income (or income statement if presented) together with a total column. No total column is required under EU-IFRS.



# 06 Statement of changes in equity and statement of income and retained earnings

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## OVERVIEW OF REQUIREMENTS

- A separate statement of changes in equity is required if changes to equity arise from items other than profit or loss, payment of dividends, corrections of prior period material errors or changes in accounting policy.
  - Otherwise, a combined statement of income and retained earnings can be presented instead of separate statements of comprehensive income and of changes in equity.
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## FRS 102

### Section 6

#### Statement of changes in equity

6.1 The statement of changes in equity presents the following information:

- total comprehensive income for the period. For consolidated accounts this is split between the amount that is attributable to the owners of the parent and that attributable to any non-controlling interest;
- for each component of equity, the effect of a retrospective application or restatement resulting from a change in accounting policy or correction of prior period material error; and
- for each component of equity, a reconciliation between the carrying amount at the beginning and end of the period disclosing separately:
  - profit or loss;
  - other comprehensive income (with an analysis of each item shown either in the statement of changes in equity or in the notes);
  - investments by owners (including disclosing separately the issue of shares and purchase of own share transactions);
  - dividends and other distributions to owners; and
  - changes in ownership interests in subsidiaries that do not result in a loss of control. [FRS102.6.3]

6.2 The statement of changes in equity is presented for each of the current and the comparative periods.

#### Statement of income and retained earnings

6.3 When the only changes in equity in addition to profit or loss for the period are those listed in paragraph 6.4 of this publication, an entity can choose to present a single statement of income and retained earnings in place of separate statements of comprehensive income and of changes in equity.

6.4 The statement of income and retained earnings presents the income statement information required by Section 5 *Statement of comprehensive income and income statement* and the following items:

- retained earnings at the beginning of the reporting period;
- dividends declared and paid or payable in the period;
- restatements for corrections of prior period material errors or changes in accounting policy; and
- retained earnings at the end of the reporting period. [FRS102.6.5]

6.5 When presenting a single statement of income and retained earnings it will be necessary for the items listed in paragraph 6.4 above to be presented after the format items specified in the Schedule to the Regulations as none of the items in paragraph 6.4 form part of the entity's income and expenditure for the period.

## vs previous UK GAAP

### Applicable standards: FRS 3, FRS 28

pUK6.1 Under FRS 3 a reconciliation of movements in shareholders' funds is presented as a note to the financial statements or adjacent to the other primary statements. This statement pulls together the results of the entity as presented in the profit and loss account and the statement of total recognised gains and losses, and other changes in shareholders' funds arising from transactions with shareholders, such as dividend payments, the issue of share capital and capital contributions. Unlike in FRS 102, the statement does not reconcile total equity (including non-controlling interests): it presents shareholders' funds, which exclude minority interest. Unlike FRS 102 there is no requirement for comparative movements.

## vs EU-IFRS

### Applicable standards: IAS 1, IAS 8

IFRS6.1 IAS 1 does not include any exemption from presenting a separate statement of changes in equity.

IFRS6.2 IAS 1 requires greater disclosure on dividends and the related amount per share.

IFRS6.3 EU-IFRS has less guidance on the presentation of reserves. The Companies Act (and therefore UK GAAP) has specific requirements regarding this presentation, e.g. share capital, share premium, capital redemption reserve.



# 07 Statement of cash flows

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## OVERVIEW OF REQUIREMENTS

- Qualifying group entities are not required to present a cash flow statement in their individual financial statements.
  - Cash flows are presented in the statement of cash flows classified by operating, investing and financing activities.
  - Net cash flows from all three categories are totalled to show the change in cash and cash equivalents during the period. Opening cash and cash equivalents is reconciled to the closing amount.
  - Cash and cash equivalents includes certain short-term investments and, in some cases, bank overdrafts.
  - Cash flows from operating activities may be presented using either the direct or indirect method.
  - Generally all financing and investing cash flows are reported gross.
  - Foreign currency cash flows are translated at the exchange rates at the dates of the cash flows, or at a rate that approximates to this (e.g. a weighted average rate).
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## FRS 102

### Section 7

#### Scope

7.1 A qualifying entity (refer to paragraph 1.24 of this publication for the definition) applying the reduced disclosure framework under FRS 102 may elect not to include a statement of cash flows in its individual financial statements. [FRS102.1.12(b)] When the appropriate conditions for this exemption are met, it is also available to the ultimate parent company in its own individual financial statements as well as subsidiaries that are consolidated into publicly available accounts.

7.2 The following entities are not required to present a cash flow statement:

- mutual life assurance companies;
- retirement benefit plans; and
- investment funds when substantially all of their investments are highly liquid investments carried at market value and a statement of changes in net assets is presented. [FRS102.7.1A]

#### Cash and cash equivalents

7.3 Cash includes cash on hand and demand deposits. [FRS102.GL] Cash equivalents are short-term highly liquid investments with an insignificant risk of their value changing, and that are readily convertible to a known amount of cash. 'Short-term' is normally considered to be three months or less from the date of acquisition.

7.4 Bank overdrafts that are repayable on demand and form an integral part of an entity's cash management are treated as a component of cash and cash equivalents. Otherwise they are considered to be financing activities. [FRS102.7.2]

7.5 A reconciliation is presented between cash and cash equivalents in the cash flow statement to the equivalent items in the balance sheet, if they are not identical. [FRS102.7.20] Entities applying Schedule 2 to the Regulations (i.e. banks) include only cash and balances at central banks and loans and advances to banks repayable on demand in their cash balance (see paragraph 4.2 of this publication). [FRS102.7.20A]

#### Operating, investing and financing activities

7.6 Cash flows are classified into those relating to operating activities, investing activities and financing activities. [FRS102.7.3]

- (a) Operating activities are the principal revenue-producing activities of the entity. Cash flows from operating activities generally relate to amounts recognised in profit or loss that are not investing or financing cash flows. [FRS102.7.4]
- (b) Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. [FRS102.7.5] They include cash flows arising from the acquisition and disposal of property, plant and equipment and subsidiaries or other business units; FRS 102 provides a list of other examples of such cash flows.
- (c) Financing activities relate to the equity and borrowings of an entity; FRS 102 provides a list of examples of such cash flows. [FRS102.7.6]

7.7 Major classes of gross cash receipts and payments arising from investing and financing activities are required to be presented separately except when net presentation is allowed (see next paragraph). [FRS102.7.10]

7.8 Cash receipts and payments may be presented net when:

- they are made on behalf of customers and reflect the customer's activities, not those of the entity, e.g. rents collected on behalf of, and paid over to, the owners of properties; [FRS102.7.10A,B]
- the turnover of the related items is quick, the amounts are large, and the maturities are short e.g. purchase and sale of investments; [FRS102.7.10A,C] or
- the entity is a financial institution, and the cash flows are listed in FRS 102.34.33 (see paragraph 34D.1 of this publication). [FRS102.7.10D]

7.9 A financial institution that effects or carries out insurance contracts includes the cash flows of its long-term business only to the extent of cash transferred and available to meet the obligations of the entity or group as a whole. [FRS102.7.10E]

7.10 Cash flows from hedging contracts are classified in the same manner as the cash flows of the item being hedged. [FRS102.7.5]

### Direct vs indirect method

7.11 There is a choice of presenting cash flows from operating activities using either:

- (a) the indirect method, when profit or loss for the period is reconciled to net cash from operations; or
- (b) the direct method, when major classes of gross cash receipts and payments are disclosed. [FRS102.7.7]

7.12 We expect that most entities will continue to apply the indirect method. In such cases, FRS 102 does not specify whether this should be presented as part of the statement or in a separate note.

### Foreign exchange differences

7.13 Cash flows arising from an entity's foreign currency transactions are translated into its functional currency at the exchange rate at the date of the cash flow or an approximate exchange rate, for example a weighted average rate for the period. [FRS102.7.11] Cash flows of foreign subsidiaries are translated at the exchange rate at the dates of the cash flows (i.e. a transaction rate) or an exchange rate that approximates the actual rate (e.g. a weighted average). [FRS102.7.12]

7.14 Unrealised foreign exchange gains and losses are not cash flows. However, to reconcile cash and cash equivalents at the beginning and the end of the period, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is presented in the statement of cash flows. The resulting unrealised gain or loss is presented separately from cash flows from operating, investing and financing activities as part of the reconciliation of movement in cash and cash equivalents. [FRS102.7.13]

### Interest and dividends

7.15 Cash flows from interest and dividends received and paid are presented separately. [FRS102.7.14] Cash flows from interest and dividends received can be classified as either operating or investing activities. [FRS102.7.15] Cash flows from interest and dividends paid can be classified as either operating or financing activities. [FRS102.7.16] The classification adopted is applied consistently from period to period.

7.16 Section 25 *Borrowing costs* permits an entity to adopt an accounting policy to capitalise borrowing costs as part of the cost of qualifying assets. When such an accounting policy is adopted, FRS 102 is silent about the treatment in the cash flow statement of such interest payments. Under FRS 102.7.5(a) cash payments to acquire property, plant and equipment (including self-constructed property, plant and equipment) are treated as investing activities. It would seem appropriate therefore to have an accounting policy under which cash flows related to capitalised interest cost are classified as part of investing activities, rather than as either operating or financing activities.

### Income tax

7.17 Cash flows arising from income tax are classified as operating activities unless they can be specifically identified with financing and investing activities. If they are split, the approach should be applied consistently and adequately disclosed, including the total amount paid. [FRS102.7.17]

7.18 It may be possible to specifically identify only some of the taxes paid as investing or financing activities. In our view, it is acceptable to allocate only those specifically identified tax cash flows to investing and financing, classifying the balance as operating activities.

### Non-cash transactions

7.19 Investing and financing transactions that do not require the use of cash or cash equivalents (for example, the conversion of debt to equity, or the acquisition of assets under a finance lease) are excluded from the statement of cash flows but are disclosed elsewhere in the financial statements. [FRS102.7.18]

### Disclosures

7.20 Disclosure is made of the amount of cash and cash equivalent balances that are not available for use by the entity. This may be due to, for example, foreign exchange controls or legal restrictions. [FRS102.7.21]

7.21 Qualifying entities applying FRS 102 are exempt from presenting a cash flow statement in their individual financial statements. See paragraph 3.8 of this publication.

## Transition

7.22 Key issues on transition when preparing a cash flow statement under FRS 102 include:

- (a) FRS 102 uses three categories (being operating activities, investing activities and financing activities) whilst FRS 1 had nine categories: all previous cash flows will therefore need to be reallocated to the new categories.
- (b) When applying the indirect method for operating activities, FRS 102 starts from the profit or loss for the period, whilst under FRS 1 the reconciliation to operating cash flow started from operating profit.
- (c) FRS 102 includes cash equivalents in the cash flow statement whilst FRS 1 generally classified these as 'liquid resources' that were excluded from cash flow statements prepared under that standard.
- (d) Under FRS 1, the exemption from preparation of a cash flow statement for subsidiary undertakings, subject to meeting the 90 percent voting rights test, existed for consolidated financial statements as well as for individual financial statements. No such exemption exists for consolidated financial statements prepared under FRS 102: a cash flow statement with comparatives will therefore need to be prepared.

## vs previous UK GAAP

## Applicable standards: FRS 1

pUK7.1 FRS 1 has a narrower definition of cash than FRS 102 with no concept of 'cash equivalents', which generally would be classified as 'liquid resources' under FRS 1. Movements in 'liquid resources' are shown separately in the cash flow statement.

pUK7.2 FRS 1 is generally more prescriptive on the classification of cash flows. The cash flow statement presents cash flows in the period classified under nine headings: cash flows from operating activities, dividends from joint ventures and associates, returns on investments and servicing of finance, taxation, capital expenditure and financial investment, acquisitions and disposals, equity dividends paid, management of liquid resources and financing. Under FRS 1, further analysis of each of these main headings in the cash flow statement may be presented on the face or in the notes.

pUK7.3 FRS 1 requires supplementary disclosures in addition to the cash flow statement, being:

- (a) reconciliation from operating profit to net cash flow from operating activities;
- (b) reconciliation of movement in cash in the period to the movement in net debt; and
- (c) analysis of changes in net debt.

pUK7.4 The reconciliations in pUK7.3(a) and (b) do not form part of the cash flow statement but each may be given either adjoining the statement or in a separate note. The analysis of changes in net debt in pUK7.3(c) is given in a note. The concept of 'net debt' does not exist under FRS 102.

pUK7.5 When applying the indirect method under FRS 1 the reconciliation to operating cash flow starts at operating profit. In contrast, FRS 102 refers to profit or loss for the period.

pUK7.6 Under FRS 1, the exemption from preparation of a cash flow statement for subsidiary undertakings applies only to those for which 90 percent or more of the voting rights are controlled within the group, provided that consolidated financial statements in which those subsidiary undertakings are included are publicly available. The definition of a qualifying entity under FRS 102 does not include a minimum ownership threshold.

pUK7.7 Under FRS 1, the conditional exemption from preparation of a cash flow statement for subsidiary undertakings is applicable for both the consolidated and individual financial statements. No exemption exists for cash flow statements in consolidated financial statements prepared under FRS 102.

pUK7.8 Under FRS 1, in the individual financial statements of a parent that prepares consolidated financial statements, a cash flow statement for the parent as an individual entity is commonly not presented.

pUK7.9 Under FRS 1, small entities are not required to present a cash flow statement<sup>1</sup>.

pUK7.10 The scope exemption for investment funds under FRS 1 is restricted to 'open-ended' investment funds.

pUK7.11 Under FRS 1, the cash outflows from acquisitions and disposals include payments made to acquire investments in subsidiary undertakings, and this shows separately any balances of cash and overdrafts acquired. FRS 102 does not explicitly require the disclosure of cash or overdrafts acquired as part of an acquisition. However, if such cash or overdraft acquired was material, it may be regarded as a major class of gross cash receipts or payments and separate presentation would be required.

pUK7.12 Under FRS 1, value changes recognised by translating cash held or due in a foreign currency at the balance sheet date are not required to be presented separately in the cash flow statement. Whilst such value changes are not cash flows, FRS 102 requires the separate presentation of foreign exchange differences relating to cash and cash equivalents in the cash flow statement.

pUK7.13 Under FRS 1 there is a choice between translating the profit and loss items at the closing rate or at an average rate for the period. FRS 102 instead allows a choice between the rate at the transaction date or an average rate for the period.

1. This exemption is retained in the small entities' version of FRS 102 (see paragraph INT.11 of this publication).

## vs EU-IFRS

### Applicable standards: IAS 7

IFRS7.1 Under IAS 7 there are no disclosure exemptions. All entities are required to present a statement of cash flows.

IFRS7.2 The reconciliation from profit to net cash from operations is, in our view, required to be presented on the face of the statement of cash flows under IAS 7. FRS 102 is silent on whether the reconciliation from profit or loss to net operating cash flow is presented on the face or in the notes.

# 08 Notes to the financial statements

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## OVERVIEW OF REQUIREMENTS

- The notes to the financial statements provide additional information, narrative descriptions and disaggregations of items presented in the primary financial statements, and information on items not recognised in the primary financial statements.
  - Judgements and uncertainty over estimates are disclosed in the notes.
-

## FRS 102

### Section 8

8.1 The notes to the financial statements provide additional information, narrative descriptions, and disaggregations of items presented in the primary financial statements together with information about items that did not qualify for recognition in the financial statements. [FRS102.8.1] This will include:

- a statement of compliance with FRS 102;
- a summary of significant accounting policies (including the measurement bases used to prepare the financial statements and other accounting policies relevant to users' understanding);
- other supporting information for items presented in the primary financial statements;
- any information that is not presented elsewhere and is required to be given by FRS 102, or under the Companies Act, or the Regulations, or is necessary for an understanding of the financial statements. [FRS102.8.4]

8.2 Each section of FRS 102 sets out required disclosures that are generally presented in the notes.

8.3 In terms of their structure, the notes are normally presented on a systematic basis and cross-referenced from the primary financial statements as necessary. [FRS102.8.3]

8.4 Disclosure is required of judgements (other than those involving estimates) made by management in applying accounting policies that have a significant effect on the financial statements. [FRS102.8.6] Examples of such judgements include:

- commission revenue - determination of whether the entity acts as agent or principal;
- classification of property as investment property;
- accounting for an arrangement containing a lease; and
- lease classification either as a finance lease or an operating lease.

8.5 Information about key sources of estimation uncertainty is also disclosed when there is a significant risk of the uncertainty resulting in a material adjustment to the carrying amounts of assets or liabilities in the next financial year. In this case, the nature and carrying amount of the assets or liabilities affected is disclosed. [FRS102.8.7] Examples of estimates include:

- key assumptions used in discounted cash flow projections;
- recovery of development costs;
- utilisation of tax losses;
- measurement of defined benefit obligations; and
- provisions and contingencies.

### vs previous UK GAAP

Applicable standards: FRS 18, FRS 28

pUK8.1 There are no specific requirements under previous UK GAAP for disclosure of critical judgements or key sources of estimation uncertainty.

### vs EU-IFRS

Applicable standards: IAS 1, IAS 8

IFRS8.1 IAS 1 requires disclosure of the sensitivity of carrying amounts to the methods, assumptions and estimates applied in the financial statements.





# 09 Consolidated and separate financial statements

## OVERVIEW OF REQUIREMENTS

- A parent (an entity with subsidiaries) presents consolidated financial statements unless it meets one of the exemptions in the Companies Act.
- A parent not subject to the Companies Act applies the requirements of Section 9 unless it is not permitted to do so under its legal framework. If that framework does not require the preparation of consolidated financial statements, the entity is exempt from the requirement to prepare them.
- A subsidiary is an entity controlled by the parent. Control is the power to govern the operating and financial policies of an entity so as to obtain benefits from its activities. Control is presumed to exist when the parent owns more than half of the voting power of an entity.
- A special purpose entity (SPE) is an entity created for a narrow objective. FRS 102 sets out a number of factors to take into account in determining whether a parent has control of an SPE.
- Consolidated financial statements provide information about a group (a parent and all of its subsidiaries) as a single economic entity, combining the financial statements of the parent and subsidiaries on a line-by-line basis using uniform accounting policies. Investments in subsidiaries, the parent's proportion of equity and intra-group transactions and balances are eliminated.
- A subsidiary's financial statements used to prepare the consolidated financial statements usually have the same reporting date as the parent. If a subsidiary's reporting date is different, financial statements made up to an earlier date may be used but only if that date is no more than three months before the parent's period end.
- Any non-controlling interest in the balance sheet is presented separately within equity. Any non-controlling interest in the profit or loss for the year is disclosed separately in the statement of comprehensive income.
- Subsidiaries are included in the consolidation from the date of acquisition to the date the parent ceases to control the subsidiary.
- Any gain or loss on disposal of a subsidiary is recognised in profit or loss. The gain or loss does not include the cumulative amount of any exchange differences previously recognised in equity.
- Separate, or individual, financial statements are those in which investments in subsidiaries, associates or jointly controlled entities are carried at cost less impairment or at fair value.

## FRS 102

### Section 9

#### Interaction of FRS 102 and law

9.1 FRS 102 does not prescribe which entities prepare financial statements, and preparers subject to the Companies Act apply the Companies Act's requirements to determine whether financial statements (individual or also consolidated) are required. Section 399 of the Companies Act requires a parent company (as defined by the Companies Act) that is not subject to the small companies regime to prepare group accounts unless it qualifies for an exemption under sections 400, 401, or 402. Other companies (i.e. those that are small or qualify for one of the exemptions) are permitted to prepare consolidated accounts if they wish to do so. [FRS102.9.1]

9.2 In some cases, the requirements of FRS 102 may be inconsistent with the Companies Act. For example, FRS 102.9.9B(a) requires a group to measure certain subsidiaries held as part of an investment portfolio that are excluded from consolidation by virtue of FRS 102.9.9(b) at fair value through profit or loss. The measurement at fair value through profit or loss is a departure from the requirements of the Companies Act and the true and fair override will need to be invoked. [FRS102.ACA.51] See paragraph 3.56 of this publication.

9.3 When a parent entity does not report under the Companies Act, it follows the requirements of this chapter except to the extent that these requirements are prohibited under its statutory framework. If that framework does not require the preparation of consolidated financial statements, then the entity is exempt from the requirement to prepare them. [FRS102.9.3(g)].

#### Requirement to present consolidated accounts

9.4 The requirements in the Companies Act to prepare group accounts are largely mirrored in FRS 102, which states that consolidated financial statements (group accounts in the Companies Act) are prepared by all parent entities unless one of the following exemptions, that are derived from the Companies Act<sup>1</sup>, applies:

- The parent company is subject to the small companies regime (see sections 383 to 384 of the Companies Act).
- The parent company is a subsidiary included in a larger group that prepares consolidated financial statements and meets the requirements of sections 400 or 401 of the Companies Act, including:
  - i. The parent is itself a subsidiary (wholly-owned or meeting the conditions of section 400(1)(b) – allowing minorities to require consolidated financial statements) whose immediate parent is established in an EEA<sup>2</sup> state, and whose results are consolidated into the group financial statements of an undertaking established in an EEA state (not necessarily the immediate parent). Section 400 sets out further conditions for this exemption, including that a company that has any of its securities admitted to trading on a regulated market in an EEA state is not eligible for this exemption.
  - ii. The parent is itself a subsidiary (wholly-owned or meeting the conditions of section 401(1)(b)), its immediate parent is not established in an EEA state, and its results are consolidated into the group accounts of an undertaking (either the same parent or another) drawn up in accordance with the EU Seventh Directive or in an equivalent manner (e.g. EU-IFRS accounts, see paragraphs 1.20 to 1.22 of this publication). Section 401 sets out further conditions for this exemption, including that a company that has any of its securities admitted to trading on a regulated market in an EEA state is not eligible for this exemption.
- All of the parent's subsidiaries are excluded from consolidation under FRS 102.9.9 (see paragraph 9.6 of this publication). [FRS102.9.3]

9.5 If an entity is not a parent at the year end then it is not required to prepare consolidated accounts. [FRS102.9.2]

1. Revised Companies Act requirements apply for periods beginning on or after 1 January 2016 as set out in SI 2015/980 and the July 2015 amendments to FRS 102. Early-adoption is permitted as set out in paragraph INT.7 of this publication.

2. The European Economic Area (EEA) comprises the countries of the European Union (EU), plus Iceland, Liechtenstein and Norway. It does not include the Channel Islands, the Isle of Man, or Gibraltar.

## Exclusion of subsidiaries from consolidation

9.6 Consolidated financial statements provide information about the group as a single economic entity. They include all subsidiaries of the parent except those excluded on one of the following grounds:

- severe long-term restrictions substantially hinder the exercise of the rights of the parent over the assets or management of the subsidiary. These rights are the rights held by or attributed to the entity, in the absence of which it would not be the parent entity (see Companies Act section 405(4)); or
- the subsidiary is held exclusively for resale and has not previously been included in the consolidation. [FRS102.9.9]

9.7 A subsidiary excluded from consolidation due to severe long-term restrictions is, if the parent still exercises significant influence, equity-accounted and treated as an associate (see Chapter 14). Otherwise, the parent has an accounting policy choice to measure the subsidiary either at cost less impairment, or at fair value through other comprehensive income (OCI) with movements below cost recorded in profit or loss (see paragraph 17.23 of this publication), or at fair value through profit or loss. [FRS102.9.9A,26] The latter requires a true and fair override to be invoked. [FRS102.ACA.51]

9.8 A subsidiary that has not previously been included in the consolidation is held exclusively for resale if:

- a buyer has been identified or is being sought, and it is reasonably expected to be disposed of within approximately one year of its date of acquisition; or
- it was acquired as a result of the enforcement of a security (e.g. seized collateral), unless the subsidiary has become part of the continuing activities of the group or the holder acts as if it intends to become so; or
- it is held as part of an investment portfolio. [FRS102.GL]

9.9 A subsidiary is held as part of an investment portfolio if it is not held as a means through which the investor carries out business activities but, instead, its value to the investor is through its fair value as part of a directly or indirectly held basket of investments. When an investment fund holds an investment in another fund that itself holds a basket of investments, the basket of investments is said to be held indirectly. [FRS102.GL]

9.10 Whilst the standard refers to a portfolio containing a basket of investments, in our view that does not preclude an entity that holds only one investment from treating that investment as being its portfolio of investments. Such a treatment would be appropriate only if the investor is able to demonstrate that the investment is not held as a means by which it carries out a business but, instead, that its value to the investor is through its fair value.

9.11 Unless it is held as part of an investment portfolio, a subsidiary excluded from consolidation on the basis of not previously having been consolidated and being held exclusively for resale is accounted for in accordance with FRS 102.9.26, which gives an accounting policy choice of either cost less impairment, fair value through OCI with movements below cost recorded in profit or loss (see paragraph 17.23 of this publication), or fair value through profit or loss. If the subsidiary is held as part of an investment portfolio, it is held at fair value through profit or loss. [FRS102.9.9B]

9.12 Section 405 of the Companies Act states that a subsidiary may be excluded from consolidation if the necessary information to prepare the group accounts cannot be obtained without disproportionate expense or undue delay. FRS 102, however, states that this does not justify non-consolidation, effectively closing off the statutory option. [FRS102.9.8A]

9.13 Subsidiaries are not excluded from consolidation because the subsidiary has dissimilar business activities to the rest of the group. [FRS102.9.8]

## Control

9.14 A subsidiary is an entity that is controlled by the parent. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. [FRS102.9.4]

9.15 If a parent owns more than half of the voting power of an entity either directly or indirectly through subsidiaries, it is presumed to have control of the entity. That presumption is overcome only in exceptional circumstances in which it can be clearly demonstrated that having such ownership does not give control. [FRS102.9.5]

9.16 Control also exists when the parent does not own more than half of the voting power of an entity but has power:

- over more than half of the voting rights under an agreement with other investors;
- to govern the financial and operating policies of the entity under law or other agreement;
- to appoint or remove the majority of the members of the governing body; or
- to cast the majority of votes at meetings of the governing body. [FRS102.9.5]

9.17 Holding options or convertible instruments that are currently exercisable may also give rise to control. Control can also be achieved if a party has an agent with the ability to direct the activities for the benefit of that party. [FRS102.9.6]

9.18 Control can also exist when the parent and undertaking are managed on a unified basis, or when the parent has the power to exercise or actually exercises dominant influence or control. [FRS102.9.6A]

### Special purpose entities (SPEs)

9.19 An SPE is an entity created for a narrow objective (e.g. to effect a lease, undertake research and development activities, securitise financial assets or facilitate employee shareholdings under remuneration schemes, such as Employee Share Ownership Plans (ESOPs)). It may take the form of a corporation, trust, partnership or unincorporated entity and is often created with legal arrangements that impose strict requirements over its operations. [FRS102.9.10]

9.20 The following factors (amongst others) may indicate control of an SPE (i.e. that the SPE is a subsidiary):

- the activities of the SPE are conducted on behalf of the entity according to its specific business needs;
- the entity has the ultimate decision-making powers over the activities of the SPE even if the day-to-day decisions have been delegated;
- the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incidental to the activities of the SPE; and
- the entity retains the majority of the residual or ownership risks related to the SPE or its assets. [FRS102.9.11]

9.21 However, post-employment and other long-term employee benefit plans to which Section 28 *Employee benefits* applies are scoped out of the above requirements and so are not liable to consolidation. Employee share ownership plan trusts and similar plans related to share-based payment arrangements are outside the scope of Section 28 and hence are within this section. However, they are examples of intermediate payment arrangements, for which FRS 102 makes special provision as set out below. [FRS102.9.12]

#### Example 9.1 Special purpose entities

Company A transfers some receivables to an SPE for 90% of their face value because the expected credit losses are 10%. At the same time, the SPE enters into an agreement with Company B, a credit insurance company, to assume the residual credit risk associated with the receivables.

Any amounts collected in excess of the expected loss flow to B. The SPE and B are not related and the consideration paid is based on a market price for similar arrangements.

If the credit risk is assumed to be the sole risk of the SPE, then B bears all the risks and benefits and would be required to consolidate the SPE.

### Intermediate payment arrangements (IPAs)

9.22 FRS 102 includes additional guidance on the accounting for some types of SPEs, known as IPAs. Assuming that the sponsoring entity obtains economic benefits from payments to the IPA and has control of its right or other access to those economic benefits, the IPA's assets, liabilities and transactions are treated as those of the sponsoring entity – i.e. brought into its individual financial statements. [FRS102.9.34,35]

9.23 FRS 102 does not define an IPA but sets out a number of features of such arrangements. These include:

- An IPA is usually established by a sponsor and constituted as a trust (although other arrangements are possible).
- Sometimes the way that an IPA is set up leaves it with little discretion in the broad nature of its activities. In other cases, whilst the sponsor may not have the ability to direct the IPA's activities, it may give advice to the IPA or provide the information that the IPA needs in order to undertake its activities.
- IPAs are commonly used to pay employees but may also be used to compensate suppliers. Beneficiaries of IPAs may include former employees and charities.
- The precise identity of the parties that will receive payment from the IPA and the amounts that they will receive are not usually agreed at the outset.
- The sponsoring entity often has the right to veto or appoint the IPA's trustees (or directors).
- The payments made to the IPA and the payments made by the IPA are often cash. [FRS102.9.33]

9.24 Examples of IPAs include ESOP trusts and employee benefit trusts. [FRS102.9.33]

9.25 Since the assets, liabilities and transactions of IPAs (that meet the test in paragraph 9.22 of this publication) are brought into the sponsor's individual financial statements, then the fact that the IPA is a subsidiary of the sponsor is academic.

### Preparation of consolidated accounts

9.26 Subsidiaries are consolidated on a line-by-line basis, eliminating the carrying amount of the parent's investment in each subsidiary and the parent's portion of each subsidiary's equity. [FRS102.9.13(a),(b)]

9.27 Intra-group transactions and balances are eliminated on consolidation. However, intra-group losses may indicate the existence of an impairment that needs to be recognised in the consolidated financial statements. The deferred tax effect of the elimination of intra-group transactions is discussed in Chapter 29 of this publication. [FRS102.9.15]

### Consistency of accounting policies and reporting date

9.28 The financial statements of subsidiaries included in the consolidation are prepared using the same accounting policies as those used by the group. [FRS102.9.17] The consolidated financial statements are prepared using financial statements of the parent and subsidiaries prepared as of the same reporting date. If the subsidiary's reporting date is no more than three months before that of the parent, then the subsidiary's financial statements may be used for the consolidation, after adjusting for significant matters occurring between the subsidiary's reporting date and parent's reporting date. Otherwise, interim accounts are prepared by the subsidiary to the parent's reporting date. [FRS102.9.16]

### Non-controlling interest (NCI)

9.29 NCI is defined as the equity in a subsidiary not attributable, directly or indirectly, to a parent. [FRS102.GL]

9.30 Profit or loss and each component of OCI are allocated to the owners of the parent and to NCI based on their existing ownership interests. [FRS102.9.14]

9.31 NCI in the net assets is measured and presented separately from that of the parent. [FRS102.9.13d]

9.32 NCI is presented separately in the consolidated balance sheet within equity. [FRS102.9.20] NCI in the profit or loss and total comprehensive income of the group is shown separately in the statement of comprehensive income (or income statement if presented). [FRS102.9.21] See Appendix II to this publication for where NCI is presented in common profit and loss and balance sheet formats.

9.33 NCI comprises the amount of NCI at the date of the original combination calculated in accordance with Section 19 *Business combinations and goodwill* and the NCI's share of changes in equity since that date. On acquisition, the NCI is calculated as the proportionate interest in the fair value of the identifiable assets and liabilities of the acquiree. [FRS102.9.13(d)] Paragraph 9.38 of this chapter discusses the accounting for changes in NCI that result from changes in the parent's controlling interest in a subsidiary (but neither net assets nor goodwill are adjusted by the price paid/received and the change is dealt with as an equity transaction).

9.34 The possible exercise or conversion of options or convertible instruments is not taken into account when calculating the NCI's ownership interest. There are no restrictions on net liabilities of the subsidiary resulting in the NCI having a deficit (i.e. debit) balance. [FRS102.9.14,20,22]

### Contracts to acquire NCI

9.35 FRS 102 does not specifically consider the accounting for contracts that could require a group to acquire the NCI in its subsidiaries (for example, put options or forward contracts over its NCI). In the absence of specific guidance, such contracts would ordinarily be accounted for as financial instruments in accordance with Section 12 *Other financial instruments issues*.

#### Example 9.2 Financial instrument accounting

Company A holds 90% of Company B. The holder of the remaining 10% enters into a contract allowing it to sell its interest in B to A in a year's time. If the holder exercises its option, A will pay it an amount equal to 300 (the FV of the shares at the date the option is entered into, plus 10).

On entering the contract, A will record a liability for the option in its consolidated financial statements at its fair value at that date of 5.

At the date of exercise, the fair value of B has fallen to 2,800 and the holder chooses to exercise their option. Prior to exercise, A remeasures its option liability to 20 (fair value), recognising a loss of 15 in profit or loss.

At the date of exercise, NCI of 100 is recorded in A's consolidated financial statements.

A accounts for the exercise of the option as follows:

	Dr	Cr
	£	£
Option liability	20	
NCI	100	
Other equity	180	
Cash		300

9.36 However, FRS 102 requires that transactions and other events and conditions should be accounted for and presented in accordance with their substance and not merely their legal form. [FRS102.2.8] In some cases, the substance of an arrangement involving a put option or forward over NCI is such that the holder of the NCI has exchanged an interest in the subsidiary for a right to receive cash, while the parent has acquired, at the outset, the NCI in return for a liability to pay for it. In such cases we believe that the parent's accounting should follow the substance of the transaction. Doing so would result in no NCI being recorded in the group accounts but, instead, a liability for the amount payable under the forward contract would be recognised.

9.37 A group with a forward contract to acquire NCI for a fixed sum, subject to deductions for dividends by the subsidiary, is in an identical position to a group that has acquired NCI with deferred payment terms. The NCI holder has no interest in the equity of the subsidiary but, instead, has a right to deferred payment from the group. The group, in contrast, has all of the risks and rewards associated with owning the shares in the subsidiary and also has an obligation to transfer a fixed amount of cash to the third party. In such cases, we believe that the substance method should be applied.

**Example 9.3 Substance method applied to a fixed-price forward**

Company A acquires 90% of Company B (a third party) for 90, and gains control of B. At the same time, A enters into a forward contract to acquire the remaining 10% of B in a year's time for 12. The fair value of the net identifiable assets of B at the acquisition date is 80.

The substance of the transaction is that A has acquired 100% of B, paying 90 now with 12 of deferred consideration payable in a year's time.

The double entry at the time of payment (ignoring discounting) is:

	Dr	Cr
	£	£
Goodwill	22	
100% net assets of B	80	
Deferred consideration		12
Cash		90

One year on, the forward is completed. The double entry is:

	Dr	Cr
	£	£
Deferred consideration	12	
Cash		12

**Changes in NCI while maintaining control**

9.38 Transactions that result in an increase or decrease in a controlling interest in a subsidiary whilst maintaining control are treated as transactions with equity holders in their capacity as equity holders. [FRS102.9.19D, FRS102.22.19] The identifiable net assets are not revalued to fair value and no additional goodwill is recognised. [FRS102.9.19C] No profit or loss is recognised on such transactions. [FRS102.22.19]

**Example 9.4 Increasing a controlling interest**

A owns 70% of B and as such controls B. A acquires a further 10% of B for 100 cash, taking its interest to 80%. As a result of the transaction the NCI's share of B's net assets (as recorded in A's group accounts) decreases from 180 to 120.

B's net assets are not revalued and no goodwill is recorded as a result of the transaction. Instead, the journal entry is:

	Dr	Cr
	£	£
NCI	60	
Equity (attributable to the parent)	40	
Cash		100

**Disposal of subsidiaries**

9.39 The results of a subsidiary are included in the consolidation from the acquisition date (see Chapter 19 of this publication) until the date the parent loses control of the subsidiary. A parent may lose control of a subsidiary by disposal of some or all of its stake, or without a change in ownership, e.g. when a subsidiary falls under the control of a government, court, administrator or regulator. [FRS102.9.18]



9.40 Any gain or loss on loss of control is recognised in profit or loss. This is calculated as the difference between:

- the proceeds; and
- the transaction date carrying amount of the portion of the subsidiary disposed of or lost. [FRS102.9.18A]

9.41 Items recorded in OCI, in relation to the former subsidiary, are recycled through profit or loss if they would be recycled were the underlying assets or liabilities to which they relate disposed of directly. [FRS102.9.18B] The cumulative amount of exchange differences recognised in equity that relate to a foreign subsidiary is not recycled in profit or loss but is transferred within equity to retained earnings. [FRS102.9.18A]

### Example 9.5 Disposal of a subsidiary

A owns 80% of B. On 1 January 2015 A disposed of B for 100. A included the following in its consolidated balance sheet in respect of B as at 31 December 2014:

	£
Net assets (including goodwill)	80
Post-acquisition retained earnings	30
NCI	15
Revaluation reserve	5
Cash flow hedging reserve	2
Foreign currency translation reserve	3

In A's consolidated financial statements, the profit on disposal of B is 37, calculated as proceeds of 100, less the carrying amount of B of 80, adding back NCI of 15 and recycling the cash flow hedging reserve of 2. The foreign currency translation reserve and the revaluation reserve are not recycled through profit or loss.

9.42 If control is lost but a NCI is retained by the group, the group accounts for this as a financial asset, an associate or a jointly controlled entity as applicable. The proportionate retained share of the former consolidated book value of the net assets is regarded as the cost of the retained interest at the date that control is lost.

9.43 If the parent retains significant influence or joint control, the retained interest (with its cost determined as above) is accounted for in accordance with Sections 14 *Investments in associates* or 15 *Investments in joint ventures* respectively, except that the requirements of FRS 102.14.8(c), to make fair value adjustments in respect of the underlying assets and liabilities and to (re)calculate goodwill, do not apply. [FRS102.9.19]

### Exchanges of business or other non-monetary assets for an interest in a subsidiary, jointly controlled entity or associate

9.44 The exchange of a business or other non-monetary asset for an interest in an entity which is or thereby becomes a subsidiary, jointly controlled entity or associate is accounted for in the consolidated financial statements of the parent (or investor) as follows:

- to the extent that the parent or investor retains an interest (direct or indirect) in the business exchanged, it is held at its pre-transaction carrying amount;
- goodwill is recognised as the difference between the fair value of the consideration given and the fair value of the reporting entity's share of the pre-transaction identifiable net assets of the other entity. The consideration given includes that part of the business or cash or monetary assets exchanged that is no longer owned by the reporting entity. If this is difficult to value then the value of the assets acquired may be used as a best estimate;
- a gain is recognised when the fair value of the consideration received exceeds the book value of the part of the business (including any related goodwill) and any cash given up. Being unrealised this gain is recognised in OCI;
- a loss is recognised when the fair value of the consideration received is less than the book value of the part of the business (including any related goodwill) and any cash given up; [FRS102.9.31]
- no gain or loss is recognised in the rare case when the transaction lacks substance. In such a case, the circumstances are explained.

**Example 9.6**

Company X acquires a 60% controlling holding in Company Y, that thereby becomes its subsidiary (X had no pre-existing holding), in exchange for transferring its warehouse into Y. The fair value of the warehouse is 300 and its carrying amount is 250. The fair value of Y (without the warehouse) is 200. In other words, X exchanges 40% of a warehouse, fair value 120 (40% x 300), for a 60% interest in Y, fair value 120 (60% x 200). The fair value of Y's identifiable net assets is 180.

The accounting in the consolidated financial statements of X is:

- X keeps its warehouse at its pre-transaction carrying amount of 250, but recognises 100 of NCI in respect of it (40% of 250).
- X recognises the net assets of Y at 180 (fair value) and NCI of 72 (40% x 180).
- X recognises goodwill as the difference between the fair value of a 40% interest in the warehouse, 120 (40% x 300), i.e. what it gave in the exchange, and its interest in the net assets of Y, 108 (180 - NCI of 72): i.e. 120 - 108 = 12.
- X records a gain on disposal (in OCI as it is unrealised) of 20, being the difference between the fair value of the consideration received for the disposal, i.e. 60% of Y (60% x 200) 120, and 40% of the book value of the warehouse, 100 being the NCI figure in the first bullet above.

The journal entry is:

	Dr	Cr
	£	£
Net assets	180	
Goodwill	12	
NCI (100 + 72)		172
Gain in OCI		20

**Separate financial statements**

9.45 Separate financial statements are those presented by a parent in which the investments in subsidiaries, associates or jointly controlled entities are accounted for at either cost or fair value, rather than on the basis of the reported results and net assets of the investees. [FRS102.9.24]

9.46 Individual financial statements are defined by the Companies Act section 394 as accounts for the company, prepared in addition to any group accounts that it might prepare if it is a parent. They are unconsolidated financial statements and 'separate financial statements' is FRS 102's name for the individual financial statements of an entity with investments in subsidiaries, associates or jointly controlled entities.

9.47 In individual financial statements an entity accounts for investments in subsidiaries, associates and jointly controlled entities:

- at cost less impairment; or
- at fair value with changes recognised: in OCI so long as fair value is in excess of cost; and in profit or loss if fair value is below cost – see paragraph 17.23 of this publication; or
- at fair value through profit or loss. See paragraph 11.90 of this publication for guidance on fair value. [FRS102.9.25,26]

9.48 This policy choice is applied consistently for all investments in a particular class, although different policies may be applied to each class. [FRS102.9.26] For example, when some subsidiaries are held as part of an investment portfolio it may be appropriate to record them at fair value through profit or loss, with other subsidiaries recorded at cost on the basis that they form different classes of investment.

9.49 This policy choice is available whether or not the parent prepares consolidated financial statements or is exempt from doing so. [FRS102.9.26A]

9.50 When the cost model is applied, section 615 of the Companies Act allows cost to be equal to either the previous carrying amount of the investment in the transferor's books, when section 611 group reconstruction relief applies, or the nominal value of the shares issued, when section 612 merger relief applies. In both cases, fair value can instead be taken as cost. [FRS102. A4.24]

#### **Transition**

9.51 An exemption is available from retrospective application on first-time adoption of FRS 102 of certain requirements of this section of the standard, as discussed in paragraphs 35.23, and 35.39 to 35.41 of this publication.

## vs previous UK GAAP

Applicable standards: FRS 2, FRS 5, UITF 31, UITF 32, UITF 38

pUK9.1 Under FRS 2, when a subsidiary is excluded from consolidation on the basis that it is held exclusively with a view to resale it is recognised in the consolidated financial statements as a current asset at the lower of cost and net realisable value.

pUK9.2 When a parent increases its controlling interest in a subsidiary, FRS 2 requires the identifiable assets and liabilities of the subsidiary to be revalued to fair value, with any revaluation uplift being credited to the revaluation reserve, and incremental goodwill is calculated.

pUK9.3 When a parent decreases its controlling interest in a subsidiary, a gain or loss is recognised on the disposal and a proportion of goodwill is written off.

## vs EU-IFRS

Applicable standards: IAS 27, SIC-12, IFRS 10, IFRS 12

IFRS9.1 IFRS 10 (together with the related disclosure standard, IFRS 12) was effective in the EU from 1 January 2014. The definition of control in IFRS 10 differs from that in FRS 102 and as such there may be certain circumstances when a different control conclusion is reached under IFRS 10 compared to FRS 102.

IFRS9.2 If, on acquisition, a subsidiary meets the criteria to be classified as held for sale under IFRS 5, it is accounted for at the lower of cost and fair value and presented as a disposal group held for sale.

IFRS9.3 Under IFRS 3, non-controlling interests are recognised initially either at fair value or (as under FRS 102) at the proportionate share of the net assets, as a transaction-by-transaction choice.

IFRS9.4 On disposal of a foreign subsidiary, the cumulative foreign exchange differences relating to that subsidiary previously recognised in equity are recycled to profit or loss.

IFRS9.5 Investments in subsidiaries, associates or jointly controlled entities in separate financial statements are measured either at cost or in accordance with IAS 39.

IFRS9.6 There are no separate provisions for intermediate payment vehicles in IFRS.

IFRS9.7 An entity that meets the definition of an investment entity is exempt from consolidating its subsidiaries other than certain subsidiaries that provide investment-related services. Under FRS 102 an investor is exempt from consolidating interests held as part of an investment portfolio.



# 10 Accounting policies, estimates and errors

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## OVERVIEW OF REQUIREMENTS

- Accounting policies are the specific principles, bases, conventions, rules and practices used by an entity to prepare its financial statements.
  - A hierarchy of alternative sources is given to assist management in applying judgement to develop an appropriate accounting policy if FRS 102 does not cover a specific issue. Management may, but is not required to, consider the requirements and guidance of EU-IFRS.
  - Accounting policies are applied consistently.
  - Accounting policies are changed only when mandated by FRS 102 or in order to provide reliable and more relevant information.
  - Changes in accounting policies are applied retrospectively, except when mandated changes have specific transitional provisions or when (unusually) retrospective application is impracticable.
  - A change in accounting estimate is an adjustment to the carrying amount of an asset or liability, or useful life of an asset, that results from a change in the associated expected future benefits and obligations.
  - Changes in accounting estimates result from new information or new developments and accordingly are not corrections of errors.
  - Changes in accounting estimates are accounted for prospectively.
  - Material prior period errors are corrected by restating the comparative amounts.
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## FRS 102

### Section 10

10.1 Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. [FRS102.10.2]

#### Hierarchy

10.2 When an FRS or FRC Abstract does not give specific guidance, judgement is used in developing an appropriate accounting policy that results in information that is relevant and reliable. The following hierarchy of alternative sources is given to assist management in applying that judgement:

1. the requirements and guidance in an FRS or FRC Abstract dealing with similar and related issues;
2. the requirements and guidance in an applicable SORP dealing with similar and related issues; and
3. the definitions, recognition criteria, measurement concepts and pervasive principles in Section 2 *Concepts and pervasive principles*. [FRS102.10.5]

10.3 SORPs have now been issued for Further and Higher Education (March 2014), UK Authorised Funds (May 2014), Charities (July 2014), Limited Liability Partnerships (July 2014), Registered Social Housing Providers (September 2014), Pension Schemes (November 2014), and Investment Trust Companies and Venture Capital Trusts (November 2014).

10.4 Management may also, but is not required to, consider the requirements and guidance of EU-IFRS on similar and related issues. [FRS102.1.3-1.7, FRS102.10.6]

10.5 However, when required to do so (or when they decide to do so voluntarily), entities apply IAS 33, IFRS 6 or IFRS 8 as part of FRS 102. [FRS102.10.6] See paragraph 10.11 of this publication below.

#### Consistency

10.6 Accounting policies are applied consistently. If FRS 102 or another FRS or FRC Abstract specifically requires or permits items to be divided into separate categories for which different policies may be appropriate, then the policy is applied consistently within each category. [FRS102.10.7]

#### Changes to accounting policies

10.7 Accounting policies may be changed only if required by changes to FRS 102 or to another applicable FRS or FRC Abstract, or if the change results in reliable and more relevant information. [FRS102.10.8]

10.8 The introduction of accounting policies for new transactions or transactions that differ in substance from those occurring previously does not constitute a change in accounting policy. This is also the case for a change to the cost model when a reliable measure of fair value is no longer available (or vice versa) when fair value accounting is either required or permitted under FRS 102. [FRS102.10.9]

10.9 When an FRS or FRC Abstract allows a choice of accounting treatment, a change in the treatment adopted is a change in accounting policy. [FRS102.10.10]

10.10 However, the initial adoption of a policy to revalue assets is a revaluation in line with Section 17 *Property, plant and equipment* or Section 18 *Intangible assets other than goodwill* (and is therefore accounted for prospectively in the period of the revaluation) rather than a change in accounting policy to be accounted for (generally retrospectively) as described in the paragraph below. [FRS102.10.10A]

10.11 When a change in accounting policy is mandated by a change in the requirements of an FRS or FRC Abstract, the transitional provisions included in that new requirement take precedence. If the entity has elected to follow IAS 39 and/or IFRS 9 rather than Section 11 *Basic financial instruments* and Section 12 *Other financial instruments issues* and there is a change to that standard, then the transitional provisions for the change in that standard are applied. Similarly, when an entity is required to or has elected to follow IAS 33, IFRS 6 or IFRS 8 and the requirements of those standards change, an entity follows any specified transitional provisions given in those standards. For all other changes, the change is applied retrospectively by restating prior periods unless it is impracticable to determine the effect on individual prior periods. The entity makes every reasonable effort to apply the change retrospectively before concluding that it is impracticable to do so. When restatement is impracticable, the change in policy is applied prospectively from the start of the earliest period practicable (which may be the current period), with a corresponding adjustment to the opening balance of each affected component of equity. [FRS102.10.11-10.12]

10.12 To the extent practicable, disclosure is made of the nature and effect of the change in accounting policy for both the current and each prior period presented and the amount of the adjustment relating to periods before those presented. [FRS102.10.13]

### Changes in accounting estimates

10.13 A change in accounting estimate is a change in the carrying amount, expected useful life or usage pattern of an asset or liability resulting from a reassessment of the expected future benefits and obligations associated with the assets and liabilities.

10.14 New information or developments that result in changes to accounting estimates are not classified as correcting errors.

10.15 If it is difficult to make a distinction between a change in an accounting policy and a revision to an accounting estimate, then the change is treated as that of an accounting estimate. [FRS102.10.15]

10.16 Changes in accounting estimates are recognised prospectively in profit or loss from the period of change. For example, a change in the estimate of the useful life or method of recognising depreciation for property, plant and equipment is accounted for prospectively as a change in estimate by adjusting depreciation in the current and future periods. Disclosure is made of the nature and effect of the change in accounting estimate. [FRS102.10.16]

### Corrections of prior period errors

10.17 Prior period errors are omissions or misstatements in the financial statements relating to one or more prior periods arising from a failure to use (or misuse of) information that was available when the financial statements were authorised for issue, and that could reasonably have been expected to have been taken into account. Examples include mathematical mistakes, fraud and oversight of facts. [FRS102.10.19]

10.18 Omissions or misstatements are considered material if they could, individually or collectively, influence the economic decisions of the users of the financial statements. [FRS102.2.6]

10.19 Material prior period errors are corrected retrospectively in the first financial statements authorised for issue after their discovery by restating the comparative amounts, or (if the error occurred before the start of the earliest prior period presented) restating the opening balances of assets, liabilities and equity for the earliest prior period presented, unless it is impracticable to do so. [FRS102.10.21]

10.20 When it is impracticable to determine the period-specific effect of an error on comparative information, restatement is made for the earliest period for which retrospective restatement is practicable (which may be the current period). [FRS102.10.22]

10.21 The nature and extent of corrected material prior period errors are disclosed. [FRS102.10.23]

### Transition

10.22 Accounting estimates are not changed retrospectively on first-time adoption of FRS 102, as discussed in paragraph 35.10(b) of this publication. [FRS102.35.9(c)]



### vs previous UK GAAP

#### Applicable standards: FRS 3, FRS 18

pUK10.1 Under FRS 3 fundamental prior period errors are corrected retrospectively by restating the comparatives (rather than material prior period errors as under FRS 102). A fundamental error is defined by FRS 3 as an error that is 'of such significance as to destroy the true and fair view and hence the validity of the prior period financial statements'.

pUK10.2 Under FRS 3 the cumulative effect of prior period adjustments is noted at the foot of the current year statement of total recognised gains and losses. Under FRS 102 this is not included in the statement of comprehensive income, but shown only in the statement of changes in equity.

### vs EU-IFRS

#### Applicable standards: IAS 1, IAS 8

IFRS10.1 Under EU-IFRS, the hierarchy of guidance to consider in the absence of specific requirements includes pronouncements issued by other standard-setting bodies or industry practice. These sources are not included in FRS 102, except for industry practice that is documented in a Statement of Recommended Practice (SORP).

IFRS10.2 A statement of financial position as at the beginning of the earliest comparative period (i.e. a 'third balance sheet') is presented when an entity restates comparative information following a change in accounting policy, correction of an error, or reclassification of items in the financial statements.

# 11 Basic financial instruments

## OVERVIEW OF REQUIREMENTS

- An entity can choose to follow either Section 11 *Basic financial instruments* and Section 12 *Other financial instruments issues* in full, or the recognition and measurement requirements of IAS 39/IFRS 9 plus the disclosure and presentation requirements of Sections 11 and 12 in accounting for all of its financial instruments.
- A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
- Section 11 covers basic financial instruments (e.g. cash, most fixed rate and variable rate loans, accounts receivable and payable, investments in non-convertible preference shares) and is relevant to all entities. Section 12 deals with more complex financial instruments and with hedge accounting. The recognition and measurement requirements of Sections 11 and 12 do not apply to those entities adopting IAS 39/IFRS 9.
- Most leases, share-based payments and other employee benefits, an entity's own equity, financial guarantee contracts, other insurance contracts and investments in subsidiaries, associates and joint ventures are outside the scope of Sections 11 and 12.
- Financial instruments within the scope of Section 11 are measured initially at the transaction price (sometimes including transaction costs) unless the arrangement is a financing transaction, in which case the instrument is recognised at the present value of the future payments discounted at a market rate of interest.
- Subsequent measurement of debt instruments within the scope of Section 11 is at amortised cost less impairment; commitments to receive or make a loan are measured at cost less impairment. The fair value option is available for certain debt instruments.
- Investments in non-convertible preference shares, non-puttable ordinary shares and non-puttable preference shares are measured subsequently at fair value through profit or loss or, if fair value cannot be measured reliably, at cost less impairment.
- Amortised cost is measured using the effective interest method applied to expected future cash flows over the expected life of the instrument.
- Objective evidence of impairment is assessed at each period end and any impairment loss is recognised in profit or loss.
- Fair value is estimated using a three-tier hierarchy (market price; recent transaction; valuation model).
- Financial assets are derecognised when the contractual rights to cash flows expire, are settled or are transferred and the transfer meets certain conditions.
- Accounting for non-cash collateral depends on the transferee's rights.
- Financial liabilities are derecognised when the obligation is discharged, cancelled or expires, or when an exchange or a modification between an existing borrower and lender results in substantially different terms.
- A financial asset and a financial liability are offset only when there is both a legally enforceable right to offset and an intention to settle net or to settle both amounts simultaneously.

## FRS 102

### Section 11

#### Introduction

11.1 Three specific sections of FRS 102 deal with the accounting for financial instruments: Section 11 *Basic financial instruments* applies to all entities and covers recognition, derecognition, measurement and disclosure of 'basic' financial instruments; Section 12 *Other financial instruments issues* applies to entities entering into more complex financial instrument transactions, including hedge accounting; and Section 22 *Liabilities and equity* deals with the classification of financial instruments as either financial liabilities or equity and addresses the accounting for own equity and issued compound financial instruments.

11.2 FRS 102 provides entities with an accounting policy choice to apply either:

- (a) Sections 11 and 12 in full;
- (b) the recognition and measurement provisions of IAS 39 (as adopted for use in the EU) and the disclosure and presentation requirements of Sections 11 and 12; or
- (c) the recognition and measurement provisions of IFRS 9<sup>1</sup> (supplemented by the macro-hedging provisions of IAS 39, and even though not yet adopted) and the disclosure and presentation requirements of Sections 11 and 12. [FRS102.11.2]

Thus, even if an FRS 102 adopter chooses to use the recognition and measurement provisions of IAS 39 or IFRS 9, the disclosure and presentation requirements of Sections 11 and 12 apply (rather than those of IFRS 7, IFRS 13 and IAS 32 respectively).

11.3 Options (a), (b) and (c) above represent an accounting policy choice and should be applied consistently. [FRS102.11.2] Section 10 *Accounting policies, estimates and errors* provides guidance on the appropriateness of changes in accounting policies, as well as the accounting and disclosure requirements for such changes. See Chapter 10 of this publication.

11.4 When an entity has chosen to use the recognition and measurement provisions of IAS 39 under the three-way choice mentioned above, it will need to change its accounting policies once IAS 39 has been superseded by IFRS 9. The entity may also elect to switch to IFRS 9 before its mandatory effective date. Under either scenario the entity should apply the specific transitional rules set out in IFRS 9. [FRS102.10.11(b)]

11.5 Public benefit entities and other members of a public benefit entity group should refer to Section 34 *Specialised activities* for details of how to account for concessionary loans made or received. [FRS102.PBE11.1A] See Chapter 34K of this publication.

#### General definitions and scope

11.6 A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. [FRS102.11.3]

11.7 A financial asset is any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right:
  - i. to receive cash or another financial asset from another entity; or
  - ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- (d) a contract that will or may be settled in the entity's own equity instruments and:
  - i. under which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - ii. that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. [FRS102.GL]

1. For accounting periods beginning on or after 1 January 2016, entities that have made the accounting policy choice to apply the recognition and measurement provisions of IFRS 9 are subject to the following restriction: financial assets that are not permitted by relevant legislation to be measured at fair value through profit or loss are instead measured at amortised cost. Early-adoption of this amendment is permitted as discussed in paragraph INT.7 of this publication.

11.8 A financial liability is any liability that is:

- (a) a contractual obligation:
  - i. to deliver cash or another financial asset to another entity; or
  - ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) a contract that will or may be settled in the entity's own equity instruments and:
  - i. under which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - ii. will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. [FRS102.GL]

11.9 Equity is the residual interest in the assets of the entity after deducting all its liabilities. [FRS102.GL]

11.10 Tax assets and liabilities do not meet the definition of financial instruments, as they arise as a result of tax law rather than a contract between two or more parties.

11.11 Whilst the definition of financial instruments is widely drawn, not all assets and liabilities covered by that definition fall within the remit of the financial instruments sections of FRS 102. For example, certain types of financial instruments are scoped out of Section 11, because they are dealt with by other more specific sections of FRS 102. Consequently, the following financial instruments are outside the scope of Section 11 even if they otherwise meet the definition of a basic financial instrument:

- (a) Investments in subsidiaries, associates and joint ventures – see Section 9 *Consolidated and separate financial statements*, Section 14 *Investments in associates* and Section 15 *Investments in joint ventures*, respectively.
- (b) An entity's own equity and the equity component of issued compound financial instruments – see Section 22.
- (c) Leases – see Section 20 *Leases*. However, the Section 11 derecognition and impairment requirements for financial assets apply to receivables recognised by a lessor. Further, the Section 11 derecognition requirements for financial liabilities apply to finance lease payables recognised by a lessee.
- (d) Contracts, rights and obligations of employers relating to employee benefits and share-based payments – see Section 28 *Employee benefits* and Section 26 *Share-based payment*.
- (e) Insurance contracts issued, reinsurance contracts issued or held and financial instruments issued with a discretionary participation feature – see FRS 103.
- (f) Reimbursement rights – see Section 21 *Provisions and contingencies*.
- (g) Financial guarantee contracts – see Section 21. [FRS102.11.7]

11.12 When an entity follows the recognition and measurement provisions of either IAS 39 or IFRS 9 (see paragraph 11.2 of this publication), the scope of the relevant standard applies. [FRS102.11.2]

### Basic financial instrument – definition

11.13 Basic financial instruments in the scope of Section 11 are:

- (a) cash;
- (b) debt instruments (e.g. current accounts, fixed-term deposits, bonds, trade receivables and payables, loans receivable and payable) that meet certain requirements (see paragraph 11.20 of this publication);
- (c) loan commitments (from both the borrower's and lender's perspective) that cannot be settled net in cash, provided the drawn down loan is expected to meet the criteria to fall into (b) above;
- (d) investments in non-puttable ordinary shares and investments in preference shares that are both non-convertible and non-puttable. [FRS102.11.8]

11.14 Loan commitments that can contractually be settled net in cash, by either party, are not basic financial instruments and therefore fall under Section 12. Further, if the loan that results from the commitment being drawn down would not be a basic financial instrument, then the loan commitment itself also fails the definition of a basic financial instrument. These classification criteria apply to both loan commitments made by a lender and commitments received by a borrower.

11.15 Investments in subsidiaries, associates and joint ventures are outside the scope of Section 11. Other investments in ordinary shares are within the scope of Section 11 if they are non-puttable, i.e. the holder has no right to sell the shares back to the issuer (for cash or another financial asset) and there is no provision whereby the shares are automatically redeemed or repurchased on the occurrence of an uncertain future event or the death or retirement of the holder. [FRS102.22.4(a)]

11.16 Investments in preference shares are outside the scope of Section 11 (and therefore within the scope of Section 12) if they are either puttable or convertible into ordinary shares. Preference shares issued are within the scope of Section 11 if they meet the criteria for basic debt instrument classification listed in paragraph 11.20 of this publication.

11.17 Derivatives (e.g. options, warrants, futures contracts, forward contracts, interest rate swaps), asset-backed securities (e.g. collateralised mortgage obligations) and loan commitments that can be settled net in cash do not meet the criteria for basic financial instrument classification. As a result, they fall within the scope of Section 12. [FRS102.11.6]

### Debt instruments – criteria for basic financial instrument classification

11.18 FRS 102 adopts a rules-based approach to the classification of financial instruments as 'basic' or 'other'. Section 11 lists a number of detailed criteria, all of which must be met in order to qualify for basic financial instrument classification. This distinction is important since only debt instruments satisfying the definition of a basic financial instrument can be accounted for under an amortised cost model. All other debt instruments must be accounted for at fair value under Section 12.

11.19 The classification as 'basic' or 'other' financial instrument is determined at initial recognition; no reassessment is required subsequently unless there is an amendment to the contractual terms of the instrument. Whilst Section 11 is silent on the matter, in our view, reassessment is also permitted when the effective terms of a financial instrument have changed, e.g. a convertible debt instrument in which the conversion feature expires before maturity.

11.20 The criteria for basic debt instrument classification relate to:

- (a) Contractual return of the debt instrument (see paragraphs 11.21 to 11.28 of this publication).
- (b) Inflation linkage (see paragraphs 11.29 to 11.31 of this publication).
- (c) Changes in return over the life of the instrument (see paragraphs 11.32 to 11.40 of this publication).
- (d) Loss of principal or interest (see paragraphs 11.41 to 11.45 of this publication).
- (e) Prepayment features (see paragraphs 11.46 to 11.49 of this publication).
- (f) Extension (see paragraph 11.50 of this publication).

#### a) Contractual return of the debt instrument

11.21 The first criterion relates to the contractual return to the holder of the debt instrument, i.e. the lender. The return to the lender, measured in the currency in which the debt instrument is denominated, must either be:

- a fixed amount; or
- a positive fixed rate; or
- a positive variable rate; or
- a combination of a positive variable rate and a fixed margin, which may be negative. [FRS102.11.9(a)]

11.22 An example of a debt instrument for which the contractual return is a fixed amount is a zero coupon bond. Here the holder's return is the difference between the face value of the bond (e.g. £100) – which is also the amount at which the bond will be redeemed at maturity – and the issue price (e.g. £75).

11.23 Section 11 defines a variable rate (for the purpose of basic financial instrument classification) as 'a rate which varies over time and is linked to a single observable interest rate, or to a single relevant observable index of general price inflation of the currency in which the instrument is denominated, provided such links are not leveraged'.

11.24 Both quoted industry reference rates (such as LIBOR) and published rates from individual lenders (such as a bank's standard variable rate) meet the above definition of a variable rate, provided they are not leveraged (as would be the case if, for example, a loan paid interest at two times LIBOR).

11.25 A combination of a positive variable rate and a positive fixed margin (e.g. a bank's standard variable rate plus 100 basis points) or a positive variable rate and a negative fixed margin (e.g. a bank's standard variable rate minus 100 basis points) is also permitted. However, in the latter case, if there is a realistic commercial chance of the overall interest rate becoming negative and the lender being at risk of losing the principal amount, then the loan will breach the fourth criterion (loss of principal or interest) for basic debt classification.

11.26 Conversely, a combination of a positive fixed rate and a negative variable rate (e.g. 8 percent less three-month LIBOR) fails the contractual return criterion and the instrument would therefore be within the scope of Section 12.

11.27 Similarly, a loan note that pays interest based on the issuer's sales revenues or profits does not meet the definition of a basic financial instrument, as the return is not linked to an observable interest rate or an observable index of general price inflation.

11.28 An investment in a convertible loan does not meet the definition of a basic financial instrument, as the overall return to the holder depends not only on interest rates but also on the issuer's share price. For issued convertible debt, only the debt component is within the scope of either Section 11 or 12, depending on whether or not its other features meet the definition of a basic debt instrument. Conversely, the equity component of the issued convertible debt is accounted for under Section 22.

#### b) Inflation linkage

11.29 The second condition clarifies that the debt instrument may provide for repayments of either the principal amount or the return to the holder (but not both) to be linked to a single relevant observable index of general price inflation of the currency in which the debt instrument is denominated, provided that such links are not leveraged. [FRS102.11.9(aA)]

11.30 For example, for a sterling loan, interest rates linked to the UK Consumer Price Index (CPI) or Retail Price Index (RPI) are permitted. However, a mortgage rate linked to the UK Land Registry House Price Index (HPI) would fail the definition as HPI is not an index of general price inflation.

11.31 The link to the inflation index must not be leveraged. For example, if an inflation-adjusted rate were applied to an inflation-adjusted principal, the debt instrument would fail the second criterion. However, if a company issued a bond for which the principal outstanding increased each year in line with RPI and a fixed interest rate were applied to the principal amount outstanding at the start of the year and paid out during the year, although both payments of interest and principal vary with RPI, the variation in the interest payment is due solely to changes in the principal amount outstanding and not changes in the rate.

#### c) Changes in return over the life of the instrument

11.32 The third criterion deals with variations to the holder's contractual return during the life of the instrument. The contract may provide for a determinable variation provided that:

(a) the new rate meets one of the first two criteria ('contractual return' or 'inflation linkage'); and

(b) the variation is either:

- i. not contingent on future events (i.e. occurring automatically at a predetermined date); or
- ii. dependent on a contractual variable rate reaching a certain level (e.g. a cap or a floor); or
- iii. due to protect the lender against a credit deterioration of the borrower; or
- iv. due to changes in central bank levies or changes in relevant taxation or law; or
- v. due to other reasons, in which case there is the additional condition that the rate must be reset to a market rate at the date of change. [FRS102.11.9(aB)]

11.33 In summary, therefore, the third criterion is failed if the rate changes as a result of a contingent event other than those specifically listed above and the new rate is not a market rate.

11.34 Further, the variation must be ‘determinable’. Usually a variation in rate is determinable from the terms of the contract but, for example, a change in rate that can be decided unilaterally by the lender would not be considered determinable.

11.35 A common example of a variation to the contractual return during the life of the instrument is a mortgage loan with an initial fixed rate (generally discounted) that reverts to the lender’s standard variable rate after the initial tie-in period. Both the initial fixed rate and the lender’s standard variable rate meet the ‘contractual return’ criterion. Further, the variation is determinable and not contingent on future events. Therefore, the third criterion for basic financial instrument classification is met here.

11.36 Another common example is a floating rate loan with an interest rate cap, floor or collar (combination of a cap and a floor). For example, a company has taken out a five year loan under which it pays interest of six-month LIBOR plus 200 basis points, with the condition that the loan rate never falls below 2.25 percent and never exceeds 4.5 percent. The contractual variation meets the requirements for basic financial instrument classification given that the variation is determinable, it is contingent on a contractual variable rate reaching a certain level, and each of the rates satisfies the ‘contractual return’ criterion.

11.37 Section 11 clarifies that contractual terms that give the lender the unilateral option to change the terms of the contract are not considered determinable for the purpose of the above criterion. [FRS102.11.9.aB] For example, loans in the social housing sector sometimes include contractual terms permitting the lender to change the interest rate unilaterally, e.g. from a pre-determined fixed rate to a variable rate or to a different fixed rate of the lender’s choosing. The borrower typically has the option to either accept the new interest rate or to repay the debt instrument. These loans are commonly referred to as LOBOs (lender option borrower option). The Accounting Council’s Advice to the FRC to issue *Amendments to FRS 102 – Basic financial instruments and hedge accounting*, published in July 2014, specifically comments that LOBOs do not meet the ‘determinable variation’ criterion and therefore fall within the scope of Section 12.

11.38 In practice, we see many variations of the above arrangements. In each case, the classification of the debt instrument will depend on the exact facts and circumstances. It is not entirely clear what the FRC meant by ‘determinable variation’ and ‘unilateral option to change the rate’. One interpretation would be that this was intended to exclude only cases when the lender can unilaterally change the interest rate to any on- or off-market rate. Following this reading, if the lender can only change the rate to another pre-agreed rate, then the third criterion for basic debt instrument classification would be met.

11.39 For example, social landlords sometimes enter into loans with cancellable embedded swaps. These are floating rate loans (e.g. LIBOR plus 250 basis points) with an embedded interest rate swap, which essentially fixes the interest rate (e.g. at 6 percent). This interest rate fix is an integral feature of the loan agreement rather than a separately transacted swap contract. Subsequently, the lender has the right, at certain dates, to cancel the embedded interest rate swap and thus cause the loan to revert back to the original floating rate. Therefore, whilst the lender can change the rate unilaterally, the variation is nevertheless determinable as the floating rate is documented in the original loan agreement.

11.40 The third criterion applies to contractual variations included in the original loan rather than bilateral renegotiations of the original loan terms at a later date. For example, Company A takes out a five year floating rate loan with Bank B. After three years, A and B agree to change the terms of the loan agreement such that the maturity is now extended for another two years and the interest rate is fixed for the remainder of the extended term. A and B will need to consider this renegotiation under the rules for derecognition of financial liabilities and financial assets respectively (see paragraphs 11.108 and 11.98 of this publication).

#### d) Loss of principal or interest

11.41 As a fourth condition for basic financial instruments classification, the debt instrument must not include any contractual terms that could result in the lender losing the principal amount or any interest relating to the current period or prior periods. [FRS102.11.9(b)]

11.42 For example, a loan pays floating rate interest at six-month LIBOR less 100 basis points throughout the life of the loan. If there is no interest rate floor then the contractual rate could fall below zero. If the contractual terms were such that the lender was required to pay interest in that case – and thus effectively lose the principal amount or interest relating to prior periods – then the fourth criterion would not be met. In our view, for the purpose of that analysis, scenarios that are possible but remote need not be taken into account.

11.43 Potential loss of principal may also occur if the loan includes an option allowing the borrower to prepay the loan at fair value, as this could be lower than the carrying amount outstanding at the redemption date.



11.44 Another example is that of non-recourse finance in the form of collateralised bank loans or asset-backed securities. Typically, this involves a special purpose subsidiary borrowing funds from a third party lender or bond investors to buy certain financial or non-financial assets, e.g. a property or a portfolio of mortgage receivables. Repayments of the loan or bonds are contractually linked to the cash flows from the financed assets. As a result, the holder could lose the principal amount or any interest attributable to the current or prior periods as a result of a shortfall on the underlying assets. This is in breach of the fourth criterion for basic debt instrument classification.

11.45 Section 11 clarifies that subordination to other debt instruments does not, in itself, violate the fourth criterion. [FRS102.11.9(b)] Equally, potential loss of capital and/or interest due to a borrower's inability to make scheduled debt payments does not breach the fourth criterion, as the borrower's failure to pay is not a contractual term of the debt instrument but rather a breach of contract.

#### e) Prepayment features

11.46 The fifth criterion relates to contractual prepayment terms that either permit the borrower to prepay a debt instrument or give the lender the option to demand early repayment. Such prepayment options are basic loan features only if they are either:

- not contingent on future events; or
- contingent on a future event but exist (i) to protect the lender from credit deterioration of the borrower or a change in control of the borrower, or (ii) to protect either party against levies applied by a central bank or from changes in relevant taxation or law. [FRS102.11.9(c)]

For example, if the borrower can repay the loan early at any time after the second anniversary of the loan, then the prepayment option is not contingent on future events.

11.47 In a further example, a company issues bonds that include a clause permitting the holder to put the bond back to the company (i.e. to force early redemption) if it breaches a debt covenant or suffers a downgrade in its external credit rating. These put options are designed to protect the bond holder against credit deterioration of the borrower and therefore meet the above criterion for basic debt instrument classification.

11.48 Whilst FRS 102 talks about early repayment options held by the borrower or lender, in our view, the same considerations can be applied by analogy to any early repayment clauses that are automatically triggered on the occurrence of a future event (such as a change in control of the borrower).

11.49 Loan terms that allow the borrower to repay the debt early (sometimes referred to as 'issuer call options') frequently include an early redemption penalty. Section 11 clarifies that early redemption penalties do not, in themselves, breach the prepayment criterion. The standard does not distinguish between issuer and holder options. Further, it does not limit the early redemption penalty to compensation for loss of interest from early repayment. [FRS102.11.9(c)] Conversely, a borrower option to prepay at less than par – including an option to prepay at fair value – might result in the holder losing part of the principal and therefore fails the fourth criterion (see paragraph 11.41 of this publication).

#### f) Extension

11.50 The last criterion relates to options to extend the term of the debt instrument. Such extension options are consistent with basic loan features, as long as the contractual terms applicable during the extended period (return to the holder and other contractual provisions) satisfy all of the five criteria above. [FRS102.11.9(e)]

### Recognition and initial measurement of basic financial instruments

11.51 Initial recognition of a financial asset or liability occurs when the entity becomes party to the contractual provisions of the instrument. [FRS102.11.12]

11.52 The financial asset or liability is recognised initially as follows:

- (a) Instruments subsequently measured at cost or amortised cost: at the transaction price, including transaction costs. Transaction costs are added to the amount recognised initially for financial assets and deducted from the amount recognised initially for financial liabilities.
- (b) Instruments subsequently measured at fair value through profit or loss: at the transaction price excluding transaction costs. These will instead be charged immediately to profit or loss.



(c) Debt instruments that are, in substance, financing transactions: the instrument is measured initially at the present value of the future payments discounted at a market rate of interest for a similar debt instrument. In other words, financing transactions are recognised initially at fair value, even though FRS 102 does not use this term.

11.53 Most financial transactions are carried out on an arm's length basis and on normal commercial terms, such that the transaction price also represents the fair value of the financial instrument on initial recognition. Section 11 also provides the practical expedient to recognise all short-term debt instruments (up to one year), including those with no stated interest (such as most trade receivables and payables) at their undiscounted amount, provided they are on normal commercial terms. [FRS102.11.14(a)]

11.54 However, there may be instances when an arrangement is not on normal commercial terms. FRS 102 recognises this and has introduced special measurement rules for what it terms 'financing transactions'. A financing transaction occurs when settlement is deferred beyond normal business terms, or is financed at an interest rate that is not a market rate. [FRS102.11.13]

### Example 11.1

Y is a car dealer and usually requires cash payment.

Y has just sold a £30,000 car to Customer Z and, as an incentive, has offered a two year interest-free credit deal to Z. The commercial substance of this arrangement is a sale agreement with an implicit financing element.

Under Section 11, the receivable in Y's accounts is recognised initially at the present value of the invoiced amount, discounted at the market rate of interest for a similar debt instrument. Assuming that the market rate of interest is 10%, Y would record a sale of £24,793 ( $£30,000/(1+0.1)^2$ ) and a trade receivable for the same amount.

11.55 Interest-free (or low interest) loans are a common feature in group scenarios.

### Example 11.2

A parent company P lends £1 million to its subsidiary C for five years. The loan carries no interest but C could raise external loan finance at 8%.

Whilst the inter-company loan will eliminate on consolidation, it represents a financing transaction in the separate financial statements of P and C. Under Section 11, the loan is recognised initially at the present value of the future payments, discounted using the market rate of interest of 8%, i.e. £680,583 ( $£1 \text{ million}/(1+0.08)^5$ ).

In our view, the difference between the face value of the loan and the initial amount recognised, £319,417, should be accounted for in P's financial statements as an additional investment in C and as a capital contribution in C's financial statements.

If the loan was repayable on demand, the amount would not require discounting. This would be irrespective of the intention of the parent company to demand payment or not.

11.56 Another common example of a financing transaction is an interest-free loan to an employee. In our view, the difference between the face value of the loan and the present value of the future payments, discounted at a market rate of interest, represents employee remuneration and is accounted for in accordance with Section 28.

11.57 In some cases it may be unclear as to which rate should be taken as the market rate of interest. In the example above, subsidiary C could borrow in the market at a rate of 8 percent. However, if P had provided a guarantee over C's borrowings, thus enabling C to borrow at 6 percent instead, would the market rate be determined by reference to the guaranteed rate or the rate at which C could borrow on its own account? We expect that many entities will view the guaranteed rate as the market rate of interest.

11.58 Transaction costs are defined as ‘incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability’. Examples of costs that might qualify as transaction costs are fees and commissions paid to agents, advisers, brokers and dealers, exchange levies, transfer taxes and duties. [FRS102.GL]

11.59 The definition states clearly that only incremental costs qualify as transaction costs, i.e. costs that would not have been incurred if the financial asset or financial liability had not been acquired, issued or disposed of. In our experience, few internal costs are likely to meet this requirement.

### Subsequent measurement

11.60 Investments in shares within the scope of Section 11 (i.e. investments in non-puttable ordinary shares and investments in preference shares that are both non-convertible and non-puttable) are measured at fair value through profit or loss if fair value can be measured reliably. This is the case, for example, if the shares are publicly traded. However, FRS 102 is clear that even unquoted shares generally have a reliably measurable fair value because there is either insignificant variability in the range of fair value estimates, or a reasonable estimate of the fair value can be calculated by probability-weighting the possible outcomes. [FRS102.11.30]

11.61 For investments in shares subsequently measured at fair value through profit or loss, initial transaction costs are expensed immediately (see paragraph 11.58 of this publication). Other investments in non-convertible preference shares and non-puttable ordinary or preference shares are measured at cost (including transaction costs) less impairment. [FRS102.11.14(d)]

11.62 Debt instruments within the scope of Section 11 are measured at amortised cost using the effective interest method (see paragraphs 11.68 to 11.76 of this publication), unless the fair value option has been invoked. Amortised cost accounting applies to basic debt instruments both held and issued, irrespective of whether or not the debt instrument is listed. For example, investments in listed bonds are not precluded from amortised cost accounting, subject to the criteria in FRS 102.11.9 being met.

11.63 However, the same conclusions do not apply to preference shares. Investments in preference shares must always be held at fair value through profit or loss (assuming that the fair value can be measured reliably), even if a loan or bond with the same terms meets the six criteria for amortised cost classification. Conversely, preference shares issued are accounted for at amortised cost if they comply with the criteria for basic debt classification.

11.64 For financial assets, the amortised cost amount includes, when necessary, a reduction for impairment or uncollectability. Short-term debt instruments (receivable or payable within one year) that are not financing transactions are measured at their undiscounted amounts receivable or payable. Financing transactions are measured using a market rate of interest for a similar debt instrument.

11.65 A commitment to receive or make a loan within the scope of Section 11 is measured at cost less impairment. In our experience, the cost of a loan commitment is often nil.

### Fair value option

11.66 Debt instruments that otherwise meet the criteria for amortised cost classification may, under certain circumstances, be designated as at fair value through profit or loss. The same option applies to commitments to make or receive a loan that cannot be settled net in cash. The fair value option is available if the designation results in more relevant information because either:

- it eliminates or significantly reduces an accounting mismatch that would otherwise result from measuring assets or debt instruments or recognising gains and losses on them on different bases; or
- a group of debt instruments (or financial assets and debt instruments) is managed and its performance evaluated on a fair value basis and information is provided to key management personnel (as defined in Section 33 *Related party disclosures*) on this basis. [FRS102.11.14(b)]

The fair value option cannot be invoked for those financial instruments that are prohibited from fair value through profit or loss measurement by relevant legislation (e.g. the Companies Act). See paragraph 12.12 of this publication.

11.67 The designation of a debt instrument as at fair value through profit or loss may be used only on initial recognition.

### Amortised cost and effective interest method

11.68 Basic debt instruments held and issued are accounted for at amortised cost using the effective interest method. The effective interest rate is calculated at initial recognition of the debt instrument. It is the rate that discounts the expected future cash flows over the expected life of the instrument to the carrying amount of that instrument.

11.69 Amortised cost is the initial carrying amount less repayments, plus/minus cumulative amortisation (using the effective interest method), less any impairment. The interest expense or income for a period equals the brought forward carrying amount of the financial instrument multiplied by the effective interest rate for the period. [FRS102.11.16]

11.70 The calculation of amortised cost includes amortisation of any related fees, finance charges, transaction costs and other premiums or discounts over the expected life of the instrument, or the period to which these relate, if shorter. [FRS102.11.18] In many cases the expected life of the debt instrument matches the contractual life. However, when the debt instrument gives either the borrower or the lender an early redemption option, then the entity should assess the probability of that option being exercised when determining the expected life of the debt instrument.

11.71 Cash flows include all contractual terms of the financial instrument but do not include possible future losses not yet incurred. [FRS102.11.17]

#### Example 11.3

##### Effective interest calculation

On 1 January 20X5 company C receives a five year loan of £100,000 from its bank. Interest of 10% is payable annually in arrears and the principal will be repaid in full at maturity. C pays an upfront fee of £4,000.

The initial carrying amount of the loan in C's financial statements is £96,000 (net loan proceeds). The effective interest rate is the rate that exactly discounts the expected future cash flows to the initial carrying amount of the loan. It is determined by solving for x in the following equation:

$$\frac{10,000}{(1+x)} + \frac{10,000}{(1+x)^2} + \frac{10,000}{(1+x)^3} + \frac{10,000}{(1+x)^4} + \frac{10,000}{(1+x)^5} = 96,000$$

In this example, the effective interest rate is 11.08%. The effective interest rate is higher than the nominal interest rate of 10% because it also includes amortisation of the £4,000 upfront fee, which is charged to profit or loss as part of the effective interest rate.

The annual interest expense (in profit or loss) and the year-end amortised cost of the loan are as follows

Date	Interest expense (profit or loss) (11.08%) £	Coupon/repayment of principal (cash flow) £	Amortised cost (balance sheet) £
1 January 20X5			96,000
31 December 20X5	10,641	(10,000)	96,641
31 December 20X6	10,721	(10,000)	97,352
31 December 20X7	10,792	(10,000)	98,144
31 December 20X8	10,880	(10,000)	99,024
31 December 20X9	10,976	(110,000)	0
<b>Total</b>	<b>54,000</b>		

### Debt instruments measured at their undiscounted amount

11.72 Provided they are not financing transactions, short-term payables or receivables with no stated interest rate can be measured initially at their undiscounted amount. For these instruments, amortisation is not relevant since there is no difference between the amount at initial recognition and the maturity amount. [FRS102.11.15] Thus, in most cases, short-term receivables and payables are measured at their invoiced amount (subject to impairment in the case of receivables) until settlement.

11.73 In our view, debt instruments repayable on demand bearing a market rate of interest (for example, current accounts and bank overdrafts) should also be measured at their undiscounted principal amount, even if immediate repayment is not expected.

### Financing transactions

11.74 For financing transactions (as described in paragraph 11.54 of this publication), the effective interest rate is the market rate of interest for a similar debt instrument, as determined at initial recognition of the debt instrument.

### Changes in expected cash flows or expected life

11.75 FRS 102 requires amortised cost to be recalculated to reflect changes in expected cash flows (other than changes in a floating rate of interest), as well as changes in the expected life of the debt instrument. For example, if the debt instrument has an early repayment option and prepayment expectations change, then the amortised cost accounting must be updated. The new carrying amount is the present value of the revised estimate of future cash flows, discounted at the original effective interest rate. The difference between the revised carrying amount of the debt instrument and the previous carrying amount is recognised immediately in profit or loss. [FRS102.11.20]

### Floating rate debt instruments

11.76 For floating rate debt instruments recognised initially at an amount equal to the principal receivable or payable at maturity, the periodic re-estimation of expected cash flows (see above) has no significant effect on the carrying value of the debt instrument. Therefore, as a practical expedient, interest income or expense for such instruments is normally recognised based on the current market rate of interest. [FRS102.11.19]

### Impairment

11.77 FRS 102 uses an incurred loss model for impairment, which does not take account of future credit losses, no matter how likely.

11.78 Financial assets measured at cost or amortised cost are assessed for impairment at each period end. In addition to the financial assets in the scope of Sections 11 and 12, lease receivables recognised by a lessor are also subject to the impairment provisions in Section 11.

11.79 The impairment assessment is a two-stage process. As a first step, the entity determines whether there is objective evidence that the financial asset is impaired. The second step, which applies only if there is objective evidence of impairment, relates to the measurement and recognition of the impairment loss. [FRS102.11.21]

### Objective evidence of impairment

11.80 Equity instruments carried at cost are assessed individually for impairment, regardless of significance. Other financial assets are assessed individually if significant, or else in groups with similar credit risk characteristics. [FRS102.11.24]

11.81 There is no further guidance in Section 11 specifying when a financial asset would be considered 'individually significant' or when different financial assets should be viewed as sharing 'similar credit risk characteristics'. Therefore, this is an area in which management will need to exercise considerable judgement. In our view, the methodology used should be applied consistently but kept under active review to reflect changes in the customer base or credit environment.

11.82 In our experience, the grouping along similar credit characteristics is often based, for example, on credit risk grades, types of loan, geographic location of the borrower, type of collateral, ageing profile or maturity.

11.83 Under the incurred loss model, an impairment loss may be recognised only if there is objective evidence that a loss has occurred as a result of one or more past events ('loss events').

11.84 Section 11 lists a number of potential indicators that a financial asset may be impaired. These include:

- significant financial difficulty or probable bankruptcy of the borrower or issuer of the financial instrument;
- contract breach, e.g. default on contractual payments;
- renegotiation of the terms of the financial instrument or other concession granted to the borrower or issuer;
- decrease in the estimated future cash flows from a group of financial assets linked to adverse changes in the national or local economy or adverse industry conditions. [FRS102.11.22]

#### Measurement of impairment loss

11.85 If there is objective evidence of impairment, the second step relates to the recognition and measurement of the impairment loss.

11.86 For debt instruments measured at amortised cost, impairment is measured as the difference between the carrying value and the present value of the revised estimated cash flows discounted at the asset's original effective interest rate. [FRS102.11.25(a)] In other words, the impairment loss is recognised on a present value basis. In subsequent periods, the impaired financial asset will accrete up to the revised payments expected to be received.

11.87 In our view, the appropriate discount rate for floating rate instruments is the current effective interest rate determined under the original terms of the contract, i.e. the current benchmark interest rate (e.g. current six-month LIBOR) plus/minus the original credit risk spread (e.g. 100 basis points).

11.88 For assets measured at cost less impairment (i.e. commitments to receive or make a loan or investments in shares when the fair value cannot be measured reliably), impairment is measured as the difference between the carrying value and the best estimate of the amount receivable on sale. [FRS102.11.25(b)] Impairment losses are recognised immediately in profit or loss. [FRS102.11.21]

#### Reversal of previous impairment losses

11.89 Impairment losses should be reversed in subsequent periods only to the extent that the reversal can be related objectively to an event occurring subsequent to the write-down, for example an improvement in the debtor's credit rating. Any reversal of a previously recorded impairment loss in a subsequent period is also recognised in profit or loss. [FRS102.11.26]

#### Fair value

11.90 A number of other sections of FRS 102 make explicit reference to the fair value guidance in Section 11, e.g. Section 9, Section 12, Section 13 *Inventories*, Section 14, Section 15, Section 16 *Investment property*, Section 17 *Property, plant and equipment*, Section 18 *Intangible assets other than goodwill*, Section 27 *Impairment of assets*, and Section 28. The guidance below applies equally to assets and liabilities measured at fair value in accordance with those sections.

11.91 FRS 102 defines fair value as 'the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction'. [FRS102.GL] Using the example of an investment in shares, Section 11 provides the following three-tier hierarchy for measuring fair values:

1. Quoted (bid) price for an identical asset in an active market.
2. Price of a recent transaction for an identical asset. If necessary, the price can be adjusted to reflect updated economic conditions or if evidence suggests that the recent transaction was not at fair value.
3. If there is no active market and no suitable recent transactions then a valuation technique is used to determine the arm's length price for the asset. [FRS102.11.27] If a reliable, commonly-used valuation method exists for this type of asset, then that technique is used. [FRS102.11.28]

The FRS 102 guidance was written in the context of valuing an asset. In our view, when using the three-tier hierarchy for the valuation of a liability, it would seem appropriate to use the 'ask' (or 'offer') price.

11.92 To the extent that quoted prices in an active market are available for an identical financial asset, these must be used to measure the asset in question. An active market is one which fulfils all of the following conditions:

- the items traded in the market are homogeneous;
- willing buyers and sellers can normally be found at any time;
- prices are available to the public. [FRS102.GL]

11.93 In an active market, price quotations are readily and regularly available and are representative of actual, regularly occurring transactions on an arm's length basis. [FRS102.11.27(a)]

11.94 If there is no active market and there are no suitable recent transactions, then a valuation technique must be used. The purpose of a valuation technique is to estimate the price at which a transaction at arm's length could have taken place on the measurement date. [FRS102.11.27(c)] For this reason the valuation process should reflect how the market overall would price the instrument in question, both in terms of the valuation technique selected (e.g. discounted cash flow model, option pricing model, price/earnings multiple) and the specific valuation inputs used (e.g. discount rates used in the model). To the extent possible the valuation technique should make use of market data rather than entity-specific inputs. [FRS102.11.29]

11.95 As explained in paragraph 11.91 of this publication, FRS 102 is clear that even unquoted shares can have a reliably measurable fair value if there is either insignificant variability in the range of fair value estimates, or a reasonable estimate of the fair value can be calculated by probability-weighting the possible outcomes. [FRS102.11.30]

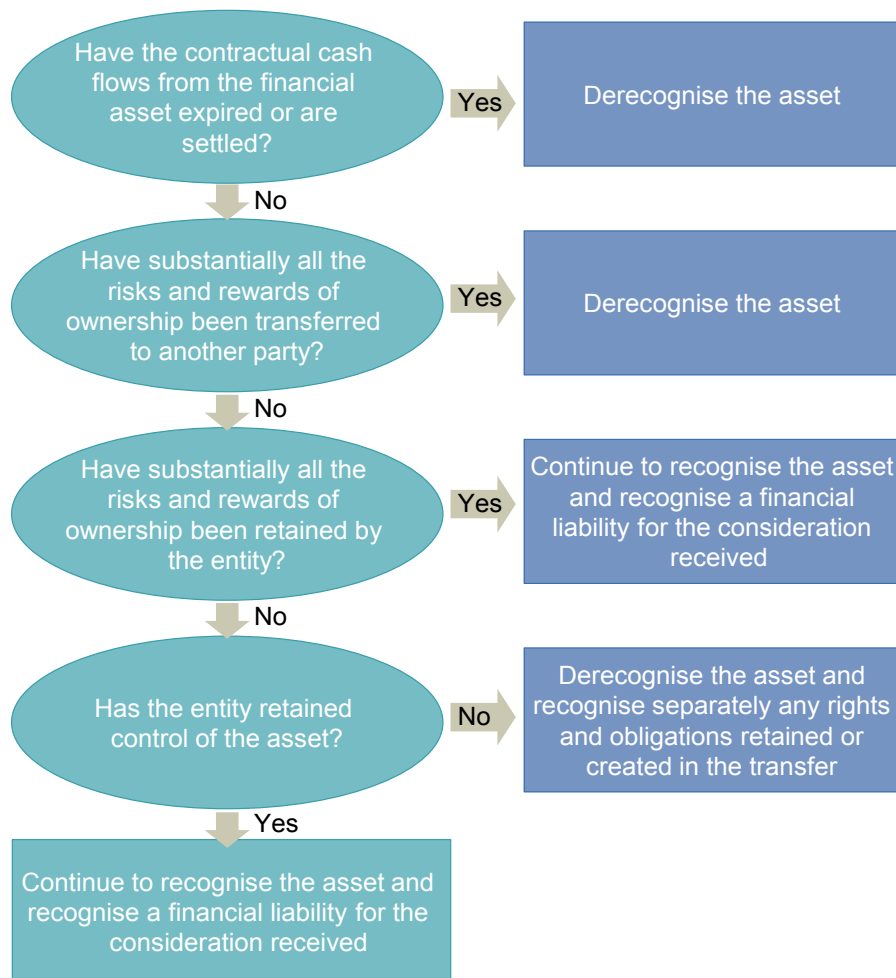
11.96 If it is not possible to measure the fair value of investments in shares reliably, the entity measures the shares at cost less impairment. This situation may arise, for example, when an investor owns shares in a start-up company with no track record and/or when shares have not been purchased purely as a financial investment.

11.97 If an entity was previously able to measure the fair value of its investments in shares reliably but is no longer able to do so, then the carrying amount at the last date the asset was measurable reliably is taken as its cost. [FRS102.11.32]

### **Derecognition of financial assets**

11.98 Section 11 includes specific provisions for derecognition of financial assets. [FRS102.11.33] These apply equally to basic financial instruments within the scope of Section 11 and other financial instruments within the scope of Section 12, given that the latter section simply cross-refers to Section 11 in this respect.

11.99 The assessment combines risks and rewards principles and control considerations, as illustrated in the following decision tree. The different tests must each be applied in sequence.



#### Have the contractual cash flows expired or are settled?

11.100 A financial asset is derecognised when the rights to the cash flows from the financial asset expire or are settled. In many cases, this question will be straightforward to answer, e.g. a bond investment is redeemed at maturity or a purchased option expires unexercised. However, in some cases more judgement will be required, notably when the original financial asset is modified or substituted for a different financial asset with the same counterparty. Often this situation arises because of financial difficulties of the borrower. Both parties negotiate a restructuring of the borrower's debt obligations, which may include, for example, reduced or suspended interest payments, extended maturity of the borrowings and amended debt covenants. In our view, the lender should consider both quantitative and qualitative aspects when assessing whether the terms of the original financial asset and the new or modified financial asset are substantially the same.

#### Risks and rewards evaluation

11.101 The next step is an assessment of whether the entity has transferred or retained substantially all the risks and rewards of ownership of the asset. There are three possible outcomes here:

- If the entity has transferred substantially all the risks and rewards of ownership of the financial asset, it derecognises the asset. The difference between the consideration received and the previous carrying value of the derecognised financial asset is recognised in profit or loss. [FRS102.11.33]
- If the entity has retained substantially all the risks and rewards of ownership of the financial asset, it continues to recognise the asset and also recognises a financial liability for the consideration received. The retained financial asset and the newly-recognised financial liability cannot be offset in the balance sheet and, in subsequent periods, income on the asset and expense on the liability are recognised separately in profit or loss. [FRS102.11.34]



(c) If the entity has neither transferred nor retained substantially all the risks and rewards of ownership of the financial asset, then the analysis moves to an evaluation of whether control has been transferred (see paragraph 11.103 of this publication).

11.102 FRS 102 does not clarify what is meant by 'substantially all risks and rewards' and thus, in some scenarios, significant judgement may be required. In our view, the assessment should consider all risks associated with the financial asset. This includes, for example:

- For equity instruments: price risk.
- For debt instruments: credit risk, slow payment risk, interest rate risk, prepayment risk.
- For both debt and equity instruments: foreign currency risk.

#### Example 11.4

Consider the following examples:

- (a) Company X transfers a portfolio of trade receivables to Bank B. The trade receivables are all denominated in X's functional currency. The main risks attached to the trade receivables are therefore credit risk and slow payment risk. X continues the credit control and must promptly send any monies received to the bank but it has no responsibility for slow or non-payment by the debtors. Therefore X has transferred substantially all the risks and rewards of the receivables and derecognises them from its balance sheet. It records the difference between cash received from the bank and the previous carrying value of the derecognised receivables in profit or loss. X also recognises a liability for cash received from customers that it has not yet passed to the bank.
- (b) Varying the example above, if X had agreed to buy back any trade receivables in default or overdue by more than 120 days, then it would have retained substantially all the risks and rewards of ownership and so would not derecognise the receivables. Instead, it would recognise the cash received from the bank as a secured loan. [FRS102.11.35]
- (c) Bank Y holds an investment in shares in a listed entity. It sells the shares to a third party for £100 but, at the same time, enters into an obligation to buy back the shares in six months' time for £102. As Y is required to buy back the shares for a fixed price, it remains exposed to the market risk of the shares. Y has therefore retained substantially all the risks and rewards of the shares and continues to recognise them in its balance sheet. Y also recognises a financial liability for the consideration received. This is, in fact, a secured loan and should accrete up to the settlement amount of £102 over the six-month period.

#### Assessment of control

11.103 If the risks and rewards analysis is inconclusive, the next step is an evaluation of control. If control of the asset has been transferred such that the transferee will be able to sell the whole financial asset externally without any restrictions, then the transferor derecognises the asset and any retained rights and obligations are recognised separately at fair value at the transfer date. Any difference between the amounts thus recognised and derecognised and the consideration received is recognised in profit or loss. [FRS102.11.33]

11.104 The 'control' test takes into account the transferee's practical ability to sell the transferred financial assets. [FRS102.11.33] Restrictions may range from an explicit prohibition in the transfer agreement from selling the asset to the absence of an active or liquid market for this type of asset. For example, in our experience, the test is not usually met for the transfer of trade receivables as the transferee would not generally be able to sell the receivables without the explicit agreement of the transferor. Conversely, it is irrelevant to the analysis whether or not the transferee actually intends to sell the asset.

11.105 When some significant risks and rewards are retained by the entity and the entity retains control of the financial asset, this does not result in derecognition of the asset, but instead the recognition of a financial liability for the consideration received. These are not offset. [FRS102.11.34]



### Non-cash collateral

11.106 If a transfer involves the provision of non-cash collateral (e.g. debt or equity instruments) by the transferor, the accounting depends on the facts and circumstances. If the transferee has no right to sell or re-pledge the collateral, the following accounting applies: [FRS102.11.35]

	Accounting by transferor	Accounting by transferee
No default by transferor	The transferor continues to recognise the collateral as an asset.	The transferee does not recognise the collateral in its accounts.
Transferor defaults under terms of contract and the lender has exercised the right to take control of the asset	The transferor derecognises the collateral.	The transferee recognises the collateral as its asset, measured initially at fair value.

11.107 If the transferee has the right by contract or custom to sell or re-pledge the collateral, the following accounting applies: [FRS102.11.35]

	Accounting by transferor	Accounting by transferee
No default by transferor	The transferor continues to recognise the collateral as an asset.	The transferee does not recognise the collateral in its accounts.  If the transferee sells the collateral, it recognises the sale proceeds and a liability (at fair value) for the obligation to return the collateral.
Transferor defaults under terms of contract and is no longer entitled to the collateral	The transferor derecognises the collateral.	If the transferee has not already sold the collateral, it recognises the collateral as its asset, measured initially at fair value.  If the transferee has already sold the collateral, it derecognises the liability to return the collateral.

### Derecognition of financial liabilities

#### Extinguishment of financial liabilities

11.108 A financial liability (or part of a financial liability) is derecognised when the obligation is discharged (e.g. cash payment is made to the lender), cancelled (e.g. the borrower is released from primary responsibility for the financial liability) or expires (e.g. an unexercised written option expires). [FRS102.11.36] Any difference between the financial liability (or part of a financial liability) derecognised and the consideration paid is recognised in profit or loss.

#### Exchange and modification of financial liabilities

11.109 The exchange between an existing lender and borrower of financial instruments with substantially different terms, or a substantial modification of an existing debt instrument, is treated by the borrower as the extinguishment of the original financial liability and the recognition of a new financial liability. [FRS102.11.37] Any difference between the carrying amount of the original and new financial liability is recognised in profit or loss. [FRS102.11.38] If the new financial liability is a basic debt instrument, then it is measured initially at the transaction price (see paragraph 11.52 of this publication), which in this case equates to the fair value of the original liability discharged.

11.110 FRS 102 does not provide specific guidance on how to evaluate whether financial instruments have substantially different terms or whether there has been a substantial modification of an existing debt instrument. Judgement will therefore be required for this assessment. However, in our view, the analysis should include both quantitative and qualitative factors. The quantitative analysis could, for example, compare the discounted present value of the cash flows under the new terms and the old terms. Examples of factors to consider in the qualitative analysis include changes in the interest rate basis from fixed to floating or vice versa, changes in the currency of the debt instrument, or significant changes in debt covenants.

11.111 FRS 102 does not provide any guidance on the accounting treatment when a change in the terms of a debt instrument is not considered a substantial modification. In our view, this should normally be treated as an adjustment to the effective interest rate applicable to the remaining term of the debt instrument and any costs associated with the restructuring should be expensed in profit or loss.

11.112 FRS 102 does not provide any specific guidance on whether fees and other costs associated with the restructuring should be capitalised and amortised as part of the effective interest rate, or whether they should be expensed immediately in profit or loss. We would expect borrowers to make an assessment based on the nature of the fees and costs and other relevant facts and circumstances.

### Debt to equity conversions

11.113 An entity may issue equity instruments to a lender in extinguishment of all or part of a financial liability. Such debt to equity conversions may be envisaged in the original contractual terms of the debt instrument (e.g. a convertible bond) or negotiated subsequently (e.g. a debt for equity swap due to financial difficulties of the borrower).

11.114 FRS 102 does not clarify how debt to equity conversions should be accounted for. On the one hand, Section 11 states that on the extinguishment of a financial liability, the difference between the previous carrying amount of the financial liability and the consideration paid should be recognised in profit or loss. [FRS102.11.38] This raises the question of whether shares issued should be viewed as 'consideration paid' for this purpose and, if so, how that consideration should be measured (e.g. fair value of the shares, fair value or carrying amount of liability extinguished).

11.115 On the other hand, Section 22 requires equity instruments issued to be measured initially at the fair value of the cash or other resources received or receivable, net of direct issue costs. [FRS102.22.8] It is unclear whether the extinguishment of a liability forms part of the 'resources received or receivable'. However, the generally accepted view is that the accounting treatment should be as follows:

- If the debt for equity conversion was envisaged in the original terms of the debt instrument (i.e. shares issued upon conversion of convertible loans or bonds), then no gain or loss should be recognised on conversion.
- For non-contractual debt for equity conversions the equity shares should be measured at the fair value of the debt with a gain or loss recognised in profit or loss, unless the transaction occurred between entities under common control.

### Presentation

11.116 Financial assets and financial liabilities are offset, and a net amount is presented in the balance sheet, if and only if both of the following conditions are met:

- (a) the entity currently has a legally enforceable right to offset the recognised amounts; and
- (b) the entity has the intention to settle on a net basis or to realise the asset and settle the liability simultaneously. [FRS102.11.38A]

11.117 The mere existence of a legal right of offset is insufficient for financial assets and financial liabilities to be offset in the balance sheet. The entity must also have the intention to settle the amounts on a net basis (or simultaneously).

11.118 In our view, an entity currently has a legally enforceable right to offset if:

- (a) the right is not contingent on a future event; and
- (b) it is enforceable both in the normal course of business and in the event of default, insolvency or bankruptcy of the entity or the counterparty.

### Example 11.5

Company A has entered into a master netting agreement with Bank B. Under the terms of this agreement all financial instruments transacted between the two parties would be offset against each other in the event of default by one of the counterparties on any one contract covered by the agreement. As the right to offset becomes enforceable only in the event of default and not on a regular day-to-day basis, this master netting agreement does not provide A with a basis for offsetting the financial assets and financial liabilities transacted with B in its balance sheet.

## Disclosures

11.119 Section 11 includes a number of disclosure requirements in relation to financial instruments.

11.120 Qualifying entities applying FRS 102 (other than those that are financial institutions, as defined – see paragraph 1.24 of this publication) that meet specified criteria are exempt from certain of these disclosure requirements.

11.121 Additional disclosures are required to be given by financial institutions under Section 34 *Specialised activities*. See Chapter 34D of this publication.

## Transition

11.122 On first-time adoption of FRS 102 an entity does not revisit its accounting for the derecognition of financial assets and financial liabilities. See paragraph 35.10(a) of this publication.

11.123 In addition, as explained in paragraph 35.25 of this publication, any financial asset or financial liability that meets the criteria for the fair value option at the transition date can be designated at fair value through profit or loss as at that date.

## vs previous UK GAAP – FRS 26 adopters

### Applicable standards: FRS 26, FRS 29, UITF 42

pUK11.1 FRS 26 adopters should refer to the 'vs EU-IFRS' section as the requirements of FRS 26 are almost identical to those of IAS 39. FRS 26 is mandatory for entities listed on an EU-regulated market and those applying the fair value accounting rules of the Companies Act.

## vs previous UK GAAP – non-FRS 26 adopters

### Applicable standards: FRS 4, FRS 5, FRS 13, UITF 11

pUK11.2 No specific accounting standards for financial assets existed under previous UK GAAP. Financial assets are accounted for in the same way as other assets. Under the Companies Act historical cost accounting rules, fixed asset investments are recognised at cost less any provisions for permanent diminutions in value; current asset debtors and investments are recognised at the lower of cost and net realisable value. Any provisions for permanent diminutions in value are charged through the profit and loss account.

pUK11.3 Under the Companies Act alternative accounting rules a fixed asset investment may be held at market or directors' valuation with movements through the statement of total recognised gains and losses; current asset investments may be held at their current cost. In practice it is more common for entities wishing to fair value to opt for fair value accounting through profit or loss and consequently apply FRS 26.

pUK11.4 Under the Companies Act, certain institutions such as banks and insurance companies are permitted to value trading book positions in transferable securities up to their net realisable value. This allows them, in effect, to fair value financial assets through profit or loss without applying the fair value accounting rules of the Act. This means they would not be required to adopt FRS 26.

pUK11.5 FRS 4 requires that debt is recognised initially at its net proceeds, being the fair value of the consideration received less issue costs. Unlike FRS 102, FRS 4 does not mandate initial recognition at fair value for loans financed at a below market rate.

pUK11.6 Derecognition under previous UK GAAP is based on the risks and rewards principles of FRS 5 rather than a combination of control and risks and rewards as under FRS 102.

## vs EU-IFRS

### Applicable standards: IAS 32, IAS 39, IFRS 7, IFRS 9<sup>1</sup>, IFRS 13, IFRIC 9, IFRIC 19

#### Classification vs IAS 39

IFRS11.1 IAS 39 has four different categories for financial assets: loans and receivables (measured at amortised cost); held-to-maturity (measured at amortised cost); available-for-sale (measured at fair value with fair value changes recorded in other comprehensive income (OCI)) and fair value through profit or loss. IAS 39 has complex rules around the initial classification (including, in some cases, assessment of intentions) and the potential reclassification of financial assets.

IFRS11.2 Financial liabilities are measured at amortised cost unless they are derivatives or trading liabilities or the fair value option has been invoked.

IFRS11.3 IAS 39 includes the concept of an 'embedded derivative', which is a component of a 'hybrid contract' (i.e. a host contract containing an embedded derivative) that affects the cash flows of the hybrid contract in a manner similar to a stand-alone derivative. IAS 39 requires separate accounting for embedded derivatives with economic characteristics not closely related to the host contract, provided the hybrid contract is not accounted for at fair value through profit or loss in its entirety.

#### Classification vs IFRS 9

IFRS11.4 Under IFRS 9 financial assets are classified at initial recognition and subsequently measured at either amortised cost, fair value through OCI or fair value through profit or loss. The classification is principle-based and depends on both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset. A fair value option exists (subject to certain restrictions) for financial assets that

1. Although not yet endorsed for use in the EU, FRS 102 allows entities to apply the recognition and measurement provisions of IFRS 9.

would otherwise be measured at amortised cost or fair value through OCI. Further, for investments in equity instruments that are not held for trading, the entity can make an election at initial recognition to present fair value changes in OCI.

IFRS11.5 As under IAS 39, financial liabilities are measured at amortised cost unless they are derivatives or trading liabilities, or the fair value option has been invoked.

IFRS11.6 Embedded derivatives with host contracts other than financial assets within the scope of IFRS 9 are assessed to determine whether the embedded derivative needs to be separated from the host contract. Embedded derivatives with host contracts that are financial assets within the scope of IFRS 9 are not separated.

### **Amortised cost measurement vs IAS 39**

IFRS11.7 Under IAS 39, financial instruments are recognised initially at fair value, which is usually the same as, or similar to, the FRS 102 requirement to measure at transaction price. Further, FRS 102 includes the practical expedient to measure short-term debt instruments, which are not financing transactions, at their undiscounted amounts payable or receivable.

IFRS11.8 The IAS 39 requirements for the subsequent measurement of financial instruments at amortised cost, including the rules governing impairment of financial assets, are broadly replicated in FRS 102.

### **Amortised cost measurement vs IFRS 9**

IFRS11.9 Financial instruments are recognised initially at fair value, except that trade receivables that do not have a significant financing component are recognised initially at the transaction price.

IFRS11.10 However, unlike FRS 102 and IAS 39, IFRS 9 adopts an 'expected loss' model (rather than an 'incurred loss' model) for financial assets subject to credit risk. As a result, a day one provision is set up for all financial assets based on expected credit losses over the next twelve months. On a significant rise in credit risk, the provision is increased to cover lifetime expected losses.

### **Fair value measurement**

IFRS11.11 IFRS 13 provides a single source of guidance on how fair value is measured and is applicable for both IAS 39 and IFRS 9 adopters. The IFRS 13 principles apply to both financial and non-financial assets and liabilities that are measured at fair value, or for which fair value is disclosed in the financial statements.

### **Derecognition**

IFRS11.12 IAS 39 and IFRS 9 have identical requirements for the derecognition of financial assets and financial liabilities. FRS 102 establishes a simplified model for the derecognition of financial assets that does not involve the concepts of 'pass-through' or 'continuing involvement' that apply to derecognition of financial assets under IAS 39/IFRS 9. Further, IAS 39/IFRS 9 define 'substantially different terms' when considering whether a renegotiated financial liability is derecognised whereas FRS 102 does not.

### **Presentation**

IFRS11.13 For both IAS 39 and IFRS 9 users the requirements for offset of financial assets and financial liabilities are included in IAS 32. The IAS 32 requirements are broadly consistent with FRS 102.

### **Disclosures**

IFRS11.14 IFRS 7 disclosure requirements for financial instruments apply to all entities using IFRS. Further, IFRS 13 requires certain disclosures for financial instruments measured at fair value. The extent of disclosures required by FRS 102 is significantly less than those required by IFRS 7 and IFRS 13.

# 12 Other financial instruments

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## OVERVIEW OF REQUIREMENTS

- An entity can choose to follow either Section 11 *Basic financial instruments* and Section 12 *Other financial instruments issues* in full, or the recognition and measurement requirements of IAS 39/IFRS 9 plus the presentation and disclosure requirements of Sections 11 and 12, in accounting for all of its financial instruments.
  - Section 12 covers other financial instruments that are not within the scope of Section 11.
  - Most leases, share-based payments and other employee benefits, an entity's own equity, financial guarantee contracts, other insurance contracts, business combinations and investments in subsidiaries, associates and joint ventures are outside the scope of Section 12.
  - Initial measurement is at fair value.
  - Subsequent measurement is at fair value through profit or loss except for those equity instruments for which fair value cannot be measured reliably; these are measured at cost less impairment.
  - Guidance from Section 11 is applied for fair value measurement, impairment and derecognition.
  - An entity can qualify for hedge accounting if specific criteria are met. This allows the matching in profit or loss or other comprehensive income of the gains or losses on the hedged item and hedging instrument.
  - There are three hedge accounting models: fair value hedge, cash flow hedge and net investment hedge.
  - A financial asset and a financial liability are offset only when there is both a legally enforceable right to offset and an intention to settle net or to settle both amounts simultaneously.
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## FRS 102

### Section 12

#### Introduction

12.1 Three specific sections of FRS 102 deal with the accounting for financial instruments. Section 11 *Basic financial instruments* applies to all entities and covers recognition, derecognition, measurement and disclosure of 'basic' financial instruments. Section 12 *Other financial instruments issues* applies to entities entering into more complex financial instrument transactions, including hedge accounting. Further, Section 22 *Liabilities and equity* deals with the classification of financial instruments as either financial liabilities or equity, and addresses the accounting for own equity and issued compound financial instruments.

12.2 As further explained in paragraph 11.2 of this publication, FRS 102 provides entities with an accounting policy choice to apply either:

- Sections 11 and 12 in full;
- the recognition and measurement provisions of IAS 39 (as adopted for use in the EU) and the disclosure and presentation requirements of Sections 11 and 12; or
- the recognition and measurement provisions of IFRS 9<sup>1</sup> (supplemented by the macro-hedging provisions of IAS 39, and even though not yet adopted) and the disclosure and presentation requirements of Sections 11 and 12. [FRS102.11.2]

12.3 Public benefit entities and other members of a public benefit entity group should refer to Section 34 *Specialised activities* for details of how to account for concessionary loans made or received. [FRS102.PBE12.1A] See Chapter 34K of this publication.

#### Scope

12.4 See Chapter 11 of this publication for the definitions of financial instruments, financial assets, financial liabilities and equity.

12.5 Section 12 applies to all financial instruments, except: [FRS102.12.3]

- (a) those dealt with by Section 11;
- (b) investments in subsidiaries, associates and joint ventures – see Section 9 *Consolidated and separate financial statements*, Section 14 *Investments in associates* and Section 15 *Investments in joint ventures*, respectively;
- (c) an entity's own equity and the equity component of issued compound financial instruments – see Section 22;
- (d) leases – see Section 20 *Leases* – other than those leases that could result in a loss for either the lessor or the lessee due to contractual terms that are not typical of such contracts (see paragraph 20.6 of this publication);
- (e) contracts, rights and obligations of employers relating to share-based payments (unless they meet the description in paragraph 12.6 of this publication) and employee benefit plans – see Section 26 *Share-based payment* and Section 28 *Employee benefits* respectively;
- (f) an acquirer's contract for contingent consideration in a business combination – see Section 19 *Business combinations and goodwill*. This scope exemption applies to contingent consideration in financial statements in which Section 19 has been applied to account for the associated business combination. Whilst the acquisition of a subsidiary (that contains a business) is not a 'business combination' in the parent's separate financial statements, in our view, an entity should make an accounting policy choice in its separate financial statements to account for contingent consideration liabilities arising on the acquisition of such investments: either by applying the same principles as would be applied to contingent consideration in a business combination under FRS 102 (see paragraph 19.9 of this publication); or by measuring such liabilities at fair value through profit or loss in accordance with Section 12. From the seller's perspective, no equivalent scope exemption is available. Accordingly, in the seller's financial statements, a contract for contingent consideration is a financial asset within the scope of Section 12;
- (g) a forward contract (covering only a reasonable period necessary to obtain relevant approvals and conclude the transaction) that will result in a future business combination – see Section 19. This scope exemption applies to both the acquirer and the seller of a business in their consolidated financial statements. It also applies to forward contracts to acquire or sell a trade and assets in separate financial statements. Consistent with the treatment of contingent consideration for the

1. For accounting periods beginning on or after 1 January 2016, entities that have made the accounting policy choice to apply the recognition and measurement provisions of IFRS 9 are subject to the following restriction: financial assets that are not permitted by relevant legislation to be measured at fair value through profit or loss are instead measured at amortised cost. Early-adoption of this amendment is permitted as discussed in paragraph INT.7 of this publication.

acquisition of investments in subsidiaries (see (f) above), we believe that an entity should make an accounting policy choice in its separate financial statements to account for forward contracts to acquire or sell subsidiaries (that would qualify for the scope exemption in the entity's consolidated financial statements): either by applying the scope exemption in Section 12 to such forward contracts by analogy; or by accounting for the forward contracts as derivatives at fair value through profit or loss in accordance with Section 12;

- (h) insurance contracts issued, reinsurance contracts issued or held and financial instruments issued with a discretionary participation feature – see FRS 103.
- (i) reimbursement rights – see Section 21 *Provisions and contingencies*;
- (j) financial guarantee contracts – see Section 21.

12.6 Contracts to buy or sell non-financial items (e.g. commodities, inventories, property, plant and equipment (PP&E)) are generally not within the scope of Section 12 as they are not financial instruments. Nevertheless such contracts are specifically brought into the scope of Section 12 if either of the following circumstances applies:

- the contract includes risks that are not typical of contracts to buy or sell non-financial items (i.e. risks that are not changes in the price of the non-financial item, foreign exchange or default by one party). We expect such contractual features to be rare in practice; or
- the contract can be settled net in cash, or with another financial instrument. However, the latter specific scope inclusion does not apply to contracts held for the entity's own expected purchase, sale or usage requirements, i.e. used in the entity's business ('own-use exemption'). [FRS102.12.4,5]

#### Example 12.1

Company C enters into a contract to buy 100kg of coffee beans at \$4/kg for delivery in 6 months. If either the contract cannot be settled net in cash or the own-use exemption applies, then the purchase contract is an executory contract outside the scope of Section 12.

Nothing will be recorded in C's financial statements until receipt of the coffee inventories, which will then be recognised at the purchase price of \$400 (in line with Section 13 *Inventories*).

Conversely, if the contract can be settled net in cash and the own-use exemption is not met, then the purchase contract is accounted for as derivative under Section 12. In our view, if C subsequently takes receipt of the coffee beans (i.e. the contract is physically settled), then the cost of that inventory also includes the fair value of the derivative at the settlement date.

If the market price of coffee beans increases to \$5 by the settlement date, the derivative has a positive fair value of \$100 at that date. The inventory is thus recognised at \$500, being the \$400 paid for the coffee plus \$100 received from settling the derivative. \$500 equates to the market price of the coffee at the date of initial recognition of the inventory.

Whilst this sets a higher cost for the inventory in the balance sheet and reduces the margin on an onwards sale accordingly, the difference has actually already been recognised as a gain in profit or loss through the fair value movements on the derivative.

12.7 Examples of financial instruments that are typically within the scope of Section 12 include derivatives (e.g. interest rate swaps, foreign currency forward contracts, interest rate caps and floors) and asset-backed securities (e.g. collateralised mortgage obligations).

12.8 When an entity follows the recognition and measurement provisions of either IAS 39 or IFRS 9 (see paragraph 12.2 of this publication), the scope of the relevant standard applies. [FRS102.12.2]



## Recognition and initial measurement

12.9 Initial recognition of a financial asset or financial liability occurs when the entity becomes party to the contractual provisions of the instrument. [FRS102.12.6]

12.10 On initial recognition, a financial asset or financial liability within the scope of Section 12 is measured at fair value. Directly attributable transaction costs are added to the amount initially recognised for financial assets and deducted from the amount initially recognised for financial liabilities, unless the instrument is classified as at fair value through profit or loss. For such instruments, the transaction costs are instead charged immediately to profit or loss. See paragraphs 11.58 to 11.59 of this publication for further guidance on transaction costs.

12.11 FRS 102 comments that the fair value on initial recognition typically equates to the transaction price. However, this is not the case for financing transactions (as defined in paragraph 11.54 of this publication), given that such arrangements are not on normal commercial terms. For financing transactions, an initial fair value is determined as the present value of future cash flows, discounted using a market rate of interest for a similar debt instrument. [FRS102.12.7]

## Subsequent measurement

12.12 Subsequent to initial recognition financial instruments within the scope of Section 12 are measured at fair value through profit or loss, subject to the following exceptions:

- Investments in equity instruments that are not publicly traded and for which fair value cannot be determined reliably are measured at cost less impairment. The same exception applies to investments in linked contracts (e.g. warrants) that, on exercise, will result in the delivery of such equity instruments. [FRS102.12.8] As explained in paragraph 11.60 of this publication, FRS 102 is clear that even unquoted shares can have a reliably measurable fair value.
- If equity instruments (or linked contracts) were previously measured at fair value but a reliable measure is no longer available, then the carrying amount at the last date the fair value of the asset was determined reliably is taken as its cost. [FRS102.12.9]
- Hedging instruments in a designated hedge relationship – see paragraphs 12.18 to 12.19 below.
- Financial instruments that are not permitted by relevant legislation (e.g. the Companies Act) to be measured at fair value through profit or loss are instead measured at amortised cost. For example, the Companies Act prohibits the measurement of financial liabilities at fair value, unless they are either: held for trading; derivatives; or permitted to be at ‘fair value through profit or loss’ under EU-IFRS. [FRS102 Appendix 4A4.12A] An example of a financial liability falling under the Companies Act prohibition is one where cash flows are linked to a non-financial variable specific to one party to the contract. Such liabilities arise primarily in insurance contracts.

12.13 The guidance in Section 11 relating to the determination of fair values (see paragraphs 11.90 to 11.97 of this publication) applies equally to financial instruments within the scope of Section 12. Section 12 includes one further provision regarding financial liabilities due on demand. The fair value of such financial liabilities is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. [FRS102.12.11] This remains true even if the financial liability is not expected to be called in the foreseeable future.

12.14 For those instruments within the scope of Section 12 that fall under the restrictions on fair value measurement in legislation, Section 12 directs entities to the provisions of Section 11 in respect of the calculation of amortised cost (see paragraphs 11.69 to 11.71 of this publication). Entities should also refer to Section 11 in respect of the impairment of assets held at cost or amortised cost (see paragraphs 11.77 to 11.89 of this publication).

## Derecognition

12.15 The Section 11 requirements regarding the derecognition of financial assets and financial liabilities apply equally to financial instruments within the scope of Section 12. See paragraphs 11.98 to 11.115 of this publication.

## Hedge accounting – introduction

12.16 Entities may be exposed to many types of financial risk such as interest rate risk, foreign exchange risk, equity price risk, commodity risk or counterparty credit risk. An entity can mitigate the financial risks arising from recognised assets and liabilities or forecast transactions by entering into derivatives (or other contracts that eliminate or reduce the exposure). This is commonly referred to as ‘hedging’.

12.17 However, whilst the entity is economically hedged through the use of derivatives (as the derivative's fair value changes or cash flows will offset those of the hedged position), an accounting mismatch may arise. This is due to FRS 102's mixed measurement model, under which various types of financial instrument are measured on different bases. In particular, certain financial assets and financial liabilities are measured at amortised cost (e.g. debt instruments meeting certain criteria) whilst others (e.g. derivatives and investments in equity instruments) are measured at fair value through profit or loss. The resulting accounting mismatch creates volatility in profit or loss. The same is true when forecast transactions (that are not yet recognised in the financial statements) are hedged with recognised derivatives. To address these issues, FRS 102 allows entities to use hedge accounting.

12.18 Under hedge accounting, an entity measures either the hedged item or the hedging instrument on a basis different from that required under the normal FRS 102 rules, such that both are recognised in either profit or loss or other comprehensive income (OCI) in the same period. This allows the economic effect of a hedge to be recognised in the financial statements. Hedge accounting is voluntary and the decision to apply hedge accounting is made on a transaction by transaction basis. However, as hedge accounting is a deviation from the normal accounting principles for financial instruments, its use is permitted only when specific criteria are met, as detailed in the next section.

12.19 In some circumstances, an entity may be able to apply the fair value option in order to address an accounting mismatch. This alternative to hedge accounting is subject to certain conditions (see paragraph 11.66 of this publication).

### Criteria for hedge accounting

12.20 A hedging relationship comprises a hedged item (e.g. a fixed rate loan) and a hedging instrument (e.g. an interest rate swap).

12.21 To qualify for hedge accounting a number of criteria must be met:

- i) the hedged item must meet certain qualifying conditions;
- ii) the hedging instrument must meet certain qualifying conditions;
- iii) the hedging relationship is in line with the entity's risk management objectives;
- iv) an economic relationship exists between the hedged item and the hedging instrument;
- v) the entity clearly documents the designated hedged risk, hedged item and hedging instrument;
- vi) the entity has identified and documented causes of hedge ineffectiveness. [FRS102.12.18]

12.22 Hedge accounting may be applied only from the date all the above conditions are met. [FRS102.12.20,23,24] In particular, this means that the relevant hedge documentation must be in place before hedge accounting can be used. However, the transitional rules for first-time adopters of FRS 102 relax the documentation requirements in the year of transition, as further explained in paragraph 12.71 of this publication.

#### (i) Hedged item

12.23 The hedged item is exposed to the specific risk that an entity has chosen to hedge. The hedged item can be any of the following: [FRS102.12.16]

- a recognised asset or liability (e.g. a fixed or floating rate loan);
- an unrecognised firm commitment, i.e. a binding agreement to purchase or sell a particular item on a specified future date (or dates) at a specified price; [FRS102.GL]
- a highly probable forecast transaction (e.g. forecast sales in a foreign currency). A forecast transaction is an uncommitted but anticipated future transaction. FRS 102 defines 'highly probable' as 'significantly more likely than not'; [FRS102.GL]
- a net investment in a foreign operation; or
- a component of any such item provided it is separately identifiable and reliably measurable.

12.24 Normally, only assets, liabilities, firm commitments or highly probable forecast transactions with an external party can be designated as the hedged item. Therefore, as a general rule, hedge accounting can be applied to transactions between entities in the same group only in the individual financial statements of those group entities. Nevertheless Section 12 permits

hedge accounting for intra-group transactions in group financial statements under certain scenarios when an intra-group transaction does not eliminate fully on consolidation, namely:

- transactions with subsidiaries that are not consolidated in the group accounts (see also Section 9);
- foreign exchange exposures on intra-group monetary items that do not eliminate fully on consolidation (as is the case if the monetary items have been transacted between group entities with different functional currencies);
- foreign currency risk of highly probable forecast transactions between group entities, when the transaction is in a currency other than the functional currency of the entity entering into the transaction, and the foreign currency risk affects consolidated profit or loss (e.g. a forecast sale of equipment between group entities, as the depreciation charge will be affected if the sale is denominated in a currency other than the buying subsidiary's functional currency). [FRS102.12.16A]

12.25 The hedged item can be a group of similar assets, liabilities, firm commitments or highly probable forecast transactions, provided that the items in the group are all individually eligible items and share the same financial risk, the entity considers these items together for risk management purposes and no offsetting risk positions are included in the group. [FRS102.12.16B]

12.26 For example, a company has a portfolio of equity investments that replicate the FTSE 100 share index. The company also holds a put option on the FTSE 100 and the investment portfolio is thus economically hedged. However, as the individual items in the portfolio do not share the same financial risk (given that the share prices of the individual components of the FTSE 100 do not all respond in the same manner to movements in the overall share index), the portfolio of equity investments does not qualify as a hedged item under FRS 102.

12.27 In a further example, a company has a sterling functional currency and routinely buys and sells items in US dollars. The company forecasts sales in US dollars to a number of different counterparties and may group these forecast sales together in a hedge of foreign exchange risk. However, forecast sales and purchases in US dollars cannot be grouped together as they have offsetting risk positions.

12.28 An entity may hedge a component of an eligible item (i.e. less than the entire fair value change or cash flow variability of an item), subject to certain restrictions. For example, the following components are permissible hedged items:

- cash flow and fair value changes due to a separately identifiable and reliably measurable component of the overall risk, e.g. hedging only for benchmark interest rate risk excluding the credit risk premium. In our view, an entity may also hedge a risk component of a non-financial item (e.g. a crude oil component in the price of jet fuel), provided it is separately identifiable and reliably measurable. In our view, a component is separately identifiable if either it is explicitly specified in a contract, or it represents an implicit price component of the entire item;
- cash flow and fair value changes above or below a certain level, e.g. hedging only against a fall in the market price of an equity investment;
- one or more selected contractual cash flows, e.g. hedging the interest rate risk for the first two years only of a bond with a five-year maturity; or
- a specified part of the nominal amount of an item, e.g. hedging only 80 percent of the nominal value of a loan. [FRS102.12.16C]

12.29 In addition, in our view, it is possible to designate a layer component as the hedged item, e.g. the first \$2 million of all expected US dollar sales in December.

#### (ii) Hedging instrument

12.30 A hedging instrument must meet all of the following qualifying conditions:

- it is a financial instrument measured at fair value through profit or loss, except that, for foreign currency hedges only, the hedging instrument may alternatively be a foreign currency debt instrument held at amortised cost;
- the instrument has been transacted with a party external to the reporting entity (e.g. a derivative transacted between a treasury subsidiary and a fellow operating subsidiary cannot be the designated hedging instrument in the consolidated financial statements that include these two subsidiaries); and

- it is not a written option (except if the written option acts as an offset to a purchased option and the combination of these derivatives is not a net written option). [FRS102.12.17,17B,17C]

12.31 Further, either the entire instrument or a proportion of the instrument must be designated as a hedging instrument. [FRS102.12.17A] Whilst the term 'proportion' has not been defined in FRS 102, it is commonly understood to indicate a certain percentage only. This is further supported by the fact that Section 12 cites '50% of the nominal amount of a financial instrument' as an example of a proportion of a financial instrument. In our view, it is not possible to designate a hedging instrument for only part of its remaining period to maturity.

12.32 In our view, the prohibition on using written options as hedging instruments extends to options embedded in other derivatives. For example, a company enters into a five-year interest rate swap with its bank. The swap agreement permits the bank to cancel the swap at any time but there is no equivalent early termination option for the company. This clause is a written option from the company's perspective and it cannot use the interest rate swap as a hedging instrument in an FRS 102 hedge relationship.

#### (iii) Hedging relationship in line with risk management objectives

12.33 The intention of FRS 102 is to allow entities to apply hedge accounting when this reflects their risk management objectives. For example, an entity may take out a number of loans, some of which will be at a fixed rate and some at a variable rate. In order to manage the overall interest rate risk, the entity has a risk management objective of maintaining a fixed rate on 40 percent to 60 percent of its borrowings. Interest rate swaps may be entered into in order to manage the fixed/variable ratio.

#### (iv) Economic relationship between hedged item and hedging instrument

12.34 One of the criteria for hedge accounting is for there to be an economic relationship between the hedged item and the hedging instrument. An economic relationship exists when the fair values or cash flows of the hedged item and the hedging instrument are typically expected to move in opposite directions in response to movements in the hedged risk. For example, a bank grants a fixed rate loan held at amortised cost. The fair value of this loan asset falls when interest rates increase (and vice versa). The bank takes out a pay-fixed, receive-floating interest rate swap as an economic hedge of the fixed rate loan. The fair value of the interest rate swap increases when interest rates rise (and vice versa). As a result, an economic relationship exists between the fixed rate loan and the interest rate swap.

12.35 In order for entities to meet their risk management objectives they would normally only enter into hedging instruments that achieve the desired offsetting effect. In our experience a hedge relationship that is consistent with an appropriate risk management objective would therefore usually meet the 'economic relationship' requirement without the need for detailed analysis.

#### (v) Hedge documentation

12.36 Before an entity can apply hedge accounting, it must document its intention to do so. FRS 102 does not prescribe a specific format for the hedge documentation. In our view, various approaches are acceptable provided that the documentation includes, as a minimum, the information specifically required by FRS 102, namely a clear description of the risk being hedged, the hedged item, the hedging instrument, and potential sources of hedge ineffectiveness. [FRS102.12.18]

#### (vi) Hedge ineffectiveness

12.37 The terms 'hedge effectiveness' and 'hedge ineffectiveness' are not defined in FRS 102. However, hedge effectiveness is generally understood to mean the degree to which changes in the fair value or cash flows of the hedged item (attributable to the hedged risk) are offset by changes in the fair value or cash flows of the hedging instrument.

12.38 Whilst FRS 102 does not require a quantitative assessment of hedge effectiveness, it nevertheless asks entities to identify and document sources of hedge ineffectiveness before they start hedge accounting. In our view, in many cases, this can be a fairly straightforward assessment such as a comparison of the principal terms of the hedged item and the hedging instrument ('critical terms matching').

### Macro-hedging

12.39 IAS 39 permits the designation of an amount of currency (rather than individual assets or liabilities) as the hedged item in a fair value hedge of interest rate exposure. This hedging technique, commonly referred to as 'macro-hedging', is

favoured by financial institutions in particular as it allows them to manage interest rate risk on an open portfolio basis, which accommodates prepayment risk (e.g. in mortgage assets) more readily.

12.40 Macro-hedging is not permitted under FRS 102. The whole language of Section 12 implies that the hedged item is a specific asset or liability (or group of specific assets or liabilities) rather than an amount of currency. Further, in its Advice to the FRC to issue *Amendments to FRS 102 – Basic financial instruments and hedge accounting*, the Accounting Council states explicitly that macro-hedging is not possible under FRS 102 and that entities wishing to apply that hedging strategy would need to make the accounting policy choice to use IAS 39 or IFRS 9 (supplemented by the macro-hedging provisions of IAS 39) instead.

12.41 Notwithstanding the prohibition on macro-hedging (i.e. a hedge of an open portfolio), it is nevertheless possible under FRS 102 to hedge groups of items (and groups of components of items). Therefore, a closed portfolio of loan assets could be designated as a hedged item in a fair value hedge of interest rate risk, provided all other Section 12 hedge requirements are met.

### Hedge accounting models – overview

12.42 FRS 102 has three different hedge accounting models. The type of model applied depends on the hedged exposure.

- A 'fair value hedge' is a hedge of changes in the fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that are attributable to a particular risk and could affect profit or loss. [FRS102.12.19(a)] A common example of a fair value hedge is the hedge of interest rate risk associated with a fixed rate loan (held at amortised cost) using an interest rate swap.
- A 'cash flow hedge' is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all (or a component) of a recognised asset or liability or a highly probable forecast transaction, and that could affect profit or loss. [FRS102.12.19(b)] Examples of cash flow hedges include a hedge of the interest rate risk associated with a floating rate debt instrument held at amortised cost (e.g. using an interest rate swap or an interest rate cap) and a hedge of the foreign exchange risk associated with highly probable forecast sales or purchases in foreign currency (e.g. using forward exchange contracts).
- A 'net investment hedge' is a hedge of the foreign currency exposure associated with an entity's net investment in a foreign operation. [FRS102.12.19(c)] This exposure could be hedged, for example, with a matching foreign currency loan.

12.43 For a hedge of the foreign currency risk of an unrecognised firm commitment, an entity has the choice of using either a fair value hedge or a cash flow hedge. [FRS102.12.19A] In our experience, cash flow hedge accounting is used more commonly in such scenarios.

### Fair value hedges

12.44 The fair value hedge accounting model can be summarised as follows: [FRS102.12.20]

Hedged risk	
Changes in fair value attributable to a particular risk	
Hedged item (modified accounting)	Hedging instrument (regular accounting)
<ul style="list-style-type: none"> <li>• Recognised asset or liability: remeasurement to fair value in respect of the hedged risk (recognised in profit or loss)</li> <li>• Unrecognised firm commitment: the change in fair value in respect of the hedged risk is recognised as an asset or liability with a corresponding entry in profit or loss</li> </ul>	<ul style="list-style-type: none"> <li>• Derivative (or, more rarely, non-derivative measured at fair value): fair value changes recognised in profit or loss</li> <li>• Foreign currency changes recognised in profit or loss</li> </ul>
Solves accounting mismatch	

12.45 In a fair value hedge the measurement of the hedged item is adjusted to take account of the effect of the hedge. This adjustment to the carrying amount of the hedged asset or liability is commonly referred to as 'basis adjustment'. The hedging instrument accounting is unchanged from normal requirements.

12.46 A fair value hedge of a firm commitment results in the entity recognising an asset or liability in the balance sheet, which represents the change in fair value of the firm commitment attributable to the hedged risk. Hedge accounting thus modifies the normal accounting rules for firm commitments (that is to say, not recognising anything until the committed transaction occurs).

12.47 If the fair value hedge is fully effective, then gains and losses recognised on the hedging instrument and on the hedged item will exactly offset each other in profit or loss. However, to the extent that the hedge is not 100 percent effective, some ineffectiveness will be charged or credited to profit or loss.

### Example 12.3

Company Z has an existing fixed rate loan held at amortised cost. As at 1 January 20X1 the loan has a carrying value of £10,000,000. Z expects interest rates to fall below the fixed rate the company is currently paying. For that reason Z has entered into an interest rate swap with a third party bank under which Z receives a fixed rate and pays a variable interest rate. The interest rate swap has an initial fair value of nil. Z designates the swap as the hedging instrument in a fair value hedge of the interest rate risk (hedged risk) associated with changes in fair value of the loan (hedged item). All conditions for hedge accounting are met. There are no accounting entries at inception of the hedge.

At 30 June 20X1 interest rates have fallen and the interest rate swap now has a fair value of £100,000. Assume that the fair value of the loan has increased by £105,000 as a result of these changes in interest rates. In other words, the hedge is not 100% effective. This could be due, for example, to the receivable leg of the interest rate swap using a different fixed rate than that charged under the loan.

Z accounts for these changes as follows as at 30 June 20X1:

	Dr £	Cr £
Fair value loss (profit or loss)	105,000	
Financial liabilities (balance sheet)		105,000
<i>To recognise the change in the carrying amount of the loan</i>		
Derivative asset (balance sheet)	100,000	
Fair value gain (profit or loss)		100,000
<i>To recognise the change in fair value of the interest rate swap</i>		

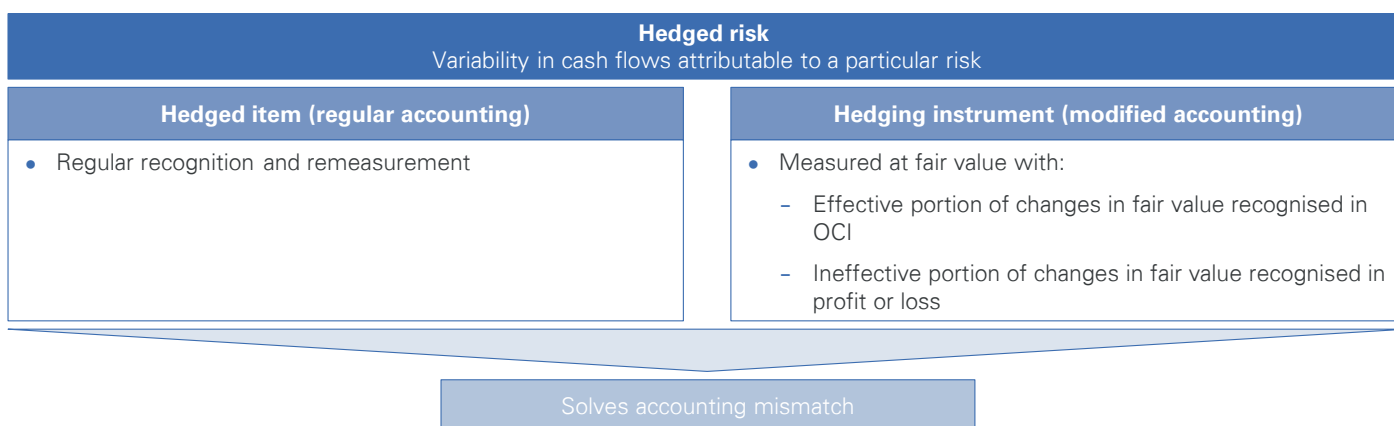
12.48 When amortised cost financial assets or liabilities are hedged under a fair value hedge, any gains or losses recognised as adjustments to the carrying amount of the financial asset or liability (as a result of hedge accounting) are subsequently amortised into profit or loss. Amortisation may start as soon as the adjustment exists and must start, at the latest, when hedge accounting ceases. The relevant amount is amortised through an adjustment of the effective interest rate of the financial asset or liability in question. [FRS102.12.22] Although not specifically stated in FRS 102, in our view, the adjustment must be fully amortised by maturity of the hedged financial asset or liability.

12.49 On settlement of a firm commitment that was subject to a fair value hedge, the amount previously recognised in the balance sheet in respect of the firm commitment is included in the initial carrying amount of the asset acquired or liability assumed. [FRS102.12.21]



## Cash flow hedges

12.50 The cash flow hedge accounting model can be summarised as follows:



12.51 In a cash flow hedge it is the accounting for the hedging instrument that is modified. If the hedging instrument is measured at fair value through profit or loss (e.g. a derivative), the effective portion of the fair value changes is instead recognised in OCI and presented in a separate component of equity ('cash flow hedge reserve'). The ineffective portion is recognised immediately in profit or loss. [FRS102.12.23(a)-(c)]

12.52 Hedging with a debt instrument held at amortised cost (e.g. a foreign currency loan) is permitted only for hedges of foreign currency risk. In this case, the effective portion of the foreign exchange movements (on retranslation of the foreign currency debt instrument) is recognised in OCI and presented in a separate cash flow hedge reserve.

### Hedge ineffectiveness

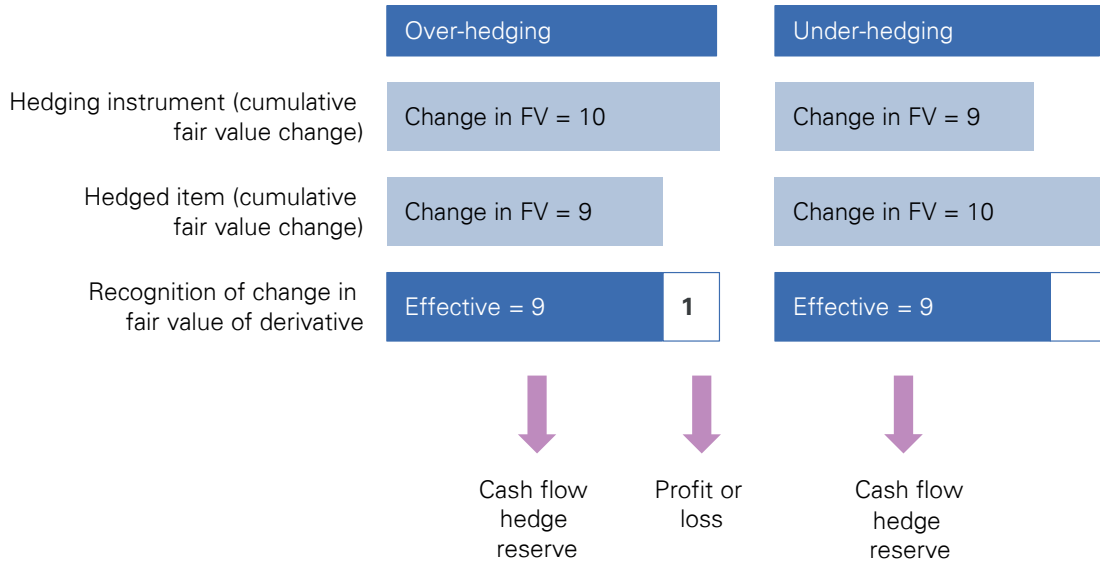
12.53 In practice, cash flow hedges are rarely 100 percent effective. Sources of ineffectiveness may include, for example:

- mismatch between the maturity date of the hedging instrument and the expected date(s) of the hedged transaction. For example, the hedging instrument typically matures on a single fixed date (e.g. forward contract with a settlement date of 15 September 20X5), whereas the hedged items (e.g. forecast foreign currency sales) occur over the entire month of September. Even if a single forecast transaction (e.g. sale of a large item of machinery to an overseas customer) expected to occur on a specific date is hedged, there may be a mismatch in dates as derivative contracts can often be found only for specific maturities (e.g. month-end dates). In addition, any changes (such as delays) in the occurrence of the hedged transaction will create hedge ineffectiveness;
- mismatch in the index or rates used by the hedging instrument and the hedged item. For example, a loan paying interest based on six-month LIBOR is hedged with an interest rate swap using three-month LIBOR as the variable rate; or
- counterparty credit risk may affect the fair value of the derivative hedging instrument.

12.54 The effective portion in a cash flow hedge is calculated according to the 'cumulative offset' method. This means that at each period end the amount in the cash flow hedge reserve is adjusted to the lower of the following (in absolute terms):

- the cumulative gain or loss on the hedging instrument from inception of the hedge; and
- the cumulative change in fair value of the hedged item from inception of the hedge. [FRS102.12.23(a)]

12.55 In other words, under a cash flow hedge, ineffectiveness due to over-hedging is recognised in profit or loss, whereas ineffectiveness due to under-hedging is not recognised (because the hedged item is not recognised in the financial statements). To illustrate:



12.56 No such calculation is needed under a fair value hedge since any hedge ineffectiveness is recognised automatically in profit or loss on re-measurement of both the hedging instrument and the hedged item.

12.57 FRS 102 does not clarify how the change in fair value of the hedged forecast cash flows should be determined. In practice, the fair value of a hypothetical derivative is often used as proxy for the fair value of the hedged item. A hypothetical derivative is a derivative that offsets the hedged cash flows perfectly, i.e. all the critical terms (such as notional amount, maturity, repricing dates, index on which a variable rate is based, etc) match. Further, the hypothetical derivative is defined such that it has zero fair value at inception.

**Subsequent accounting**

12.58 The amount accumulated in the cash flow hedge reserve (effective portion of change in fair value of the hedging instrument) is subsequently accounted for as follows: [FRS102.12.23(d)]

	Accounting for amount in cash flow hedge reserve	Examples
Hedged forecast transaction results in the recognition of a non-financial asset or non-financial liability	Include in the initial carrying amount of the non-financial asset or non-financial liability	Highly probable forecast purchase of an item of machinery (PP&E) or inventory from a foreign supplier, hedged for foreign currency risk
Other types of cash flow hedges	Reclassify to profit or loss in the same period(s) during which the hedged expected future cash flows affect profit or loss	Floating rate debt instrument: in the periods that interest income or expense is recognised  Highly probable sale: when the forecast sale occurs

If the amount in the cash flow hedge reserve is a loss, any amount of that loss not expected to be recovered is reclassified immediately to profit or loss. [FRS102.12.23(d)(iii)]



**Example 12.4**

On 1 June 20X5, Company H (with £ functional currency) is expecting highly probable sales totalling \$100,000 during August 20X5. Cash payment is due 30 days after the invoice date. H is concerned that the \$ may weaken against £, which would result in a decline in the £ revenue recognised in its financial statements. H therefore decides to hedge the foreign currency risk associated with the \$ sales and takes out a forward contract to sell \$100,000 for £65,000 on 15 September 20X5. The forward contract is assumed to be on-market, i.e. it has an initial fair value of zero.

H documents this as a cash flow hedge of the cash receipts pertaining to highly probable forecast sales in \$. A group of highly probable forecast transactions may be designated as the hedged item as the items in the group are all individually eligible items, they share the same risk, the entity considers these items together for risk management purposes and no offsetting risk positions are included in the group.

Since companies generally take out forward contracts that mature on or around the expected settlement dates of the sales invoices, assume that H expects to receive all \$ payments on 15 September 20X5, the date on which the forward contract matures.

There are no accounting entries on 1 June 20X5, as the \$ sales have not yet occurred and the forward contract has an initial fair value of zero.

During June, \$ decline in value against £ and as at 30 June 20X5 the fair value of the company's forward contract is an asset of £2,000. In this simplified example, assume that the hedge is 100% effective.

At 30 June 20X5, H records the change in fair value of the forward contract as follows:

	Dr £	Cr £
Financial asset (derivatives)	2,000	
Other comprehensive income		2,000

There is no accounting entry for the sales as these have not yet occurred. As the change in fair value of the derivative hedging instrument is recorded through OCI in the cash flow hedge reserve, there is no accounting mismatch in the income statement.

During the month of August H generates and invoices sales of \$100,000 as expected. The exchange rate during the month is \$0.62/£1. H accounts for this as follows:

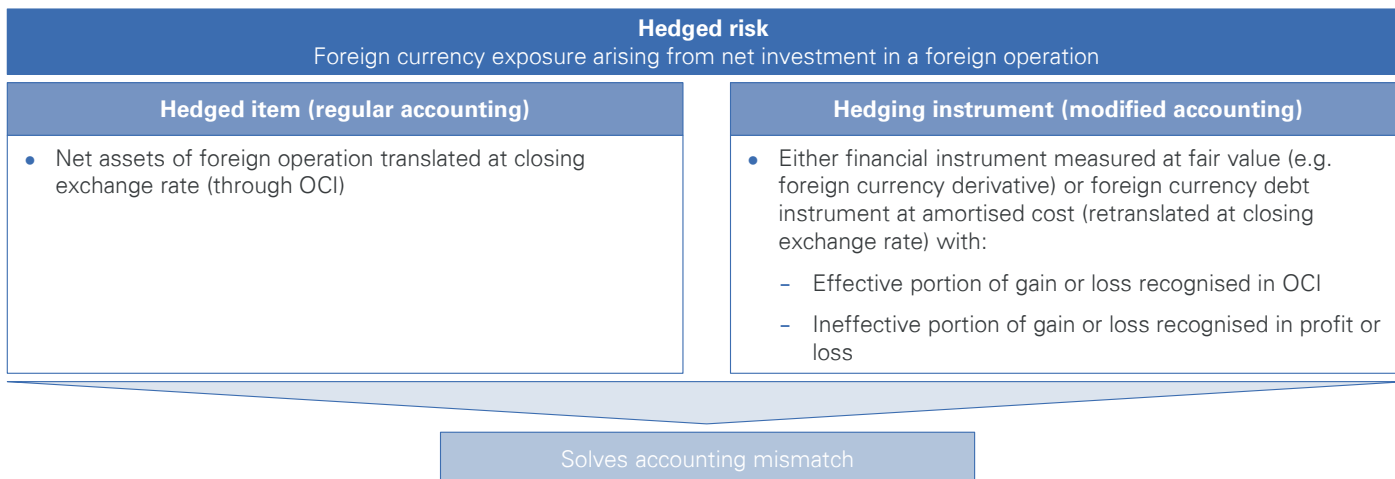
	Dr £	Cr £
Trade receivables	62,000	
Revenue		62,000
<i>To record the sales during the month of August (whether or not hedge accounting is applied, the \$ sales are recorded at the spot rate at the date of the transaction)</i>		
Financial asset (derivatives)	1,000	
Other comprehensive income		1,000
<i>To record the change in fair value in the forward contract during the month of August</i>		
Other comprehensive income	3,000	
Revenue		3,000
<i>The amount in the cash flow hedge reserve is reclassified to profit or loss when the hedged transaction (here the \$ sales) affects profit or loss.</i>		

During September 20X5 H receives payment for all \$ sales generated during August. Assume that the exchange rate throughout the month of September is £0.6/\$1 and that the forward contract has a positive fair value of £5,000 at its settlement date of 15 September. H accounts for the September transactions as follows:

	Dr £	Cr £
FX loss (profit or loss)	2,000	
Trade receivables		2,000
<i>To record the retranslation of the trade receivables up to the settlement date</i>		
Cash	60,000	
Trade receivables		60,000
<i>To record the cash settlement of the trade receivables</i>		
Financial asset (derivatives)	2,000	
Profit or loss		2,000
<i>To record the change in fair value of the FX forward contract up to the settlement date.</i>		
Cash	5,000	
Financial asset (derivatives)		5,000
<i>To record the cash settlement of the forward contract at maturity</i>		

### Net investment hedges

12.59 The net investment hedge accounting model can be summarised as follows: [FRS102.12.24]



The accounting for net investment hedges is thus similar to that for cash flow hedges. [FRS102.12.24]

12.60 In a net investment hedge, the hedged item is the foreign currency exposure on the net investment in a foreign operation. FRS 102 defines 'net investment in a foreign operation' as 'the amount of the reporting entity's interest in the net assets of that operation'. [FRS102.GL] In our view, a net investment hedge can be designated only to the extent that the financial statements include the entity's interest in the net assets of the foreign operation. This is the case for foreign subsidiaries and investments in associates and joint ventures included in consolidated financial statements. In addition, a foreign operation conducted through a branch may be designated as the hedged item in a net investment hedge in individual financial statements. However, a parent company cannot apply net investment hedging to an investment in a subsidiary, associate or joint venture in its individual financial statements. [FRS102.ACA.62]

12.61 As explained in paragraph 30.35 of this publication, goodwill and fair value adjustments arising on acquisition of a foreign operation are treated as assets and liabilities of the foreign operation. [FRS102.30.23] In the consolidated financial statements they will thus form part of the net investment in the foreign operation. In addition, monetary items receivable from or payable to a foreign operation form part of the net investment in a foreign operation if settlement is neither planned nor likely to occur in the foreseeable future. [FRS102.30.12]

### Example 12.5

Company P has borrowed \$2 million to acquire a US subsidiary at a cost of \$2 million. In its consolidated financial statements P designates the \$ loan as the hedging instrument in a hedge of the net investment in the US subsidiary. The example assumes that all qualifying conditions for hedge accounting are met.

The foreign exchange difference arising on the period end retranslation of the foreign subsidiary is recognised through OCI (see also Chapter 30 of this publication). Under normal accounting rules, the exchange difference arising on the period end retranslation of the \$ loan would be recognised in profit or loss, thus creating an accounting mismatch. However, under net investment hedge accounting, the effective portion of the foreign exchange differences on the loan is instead recognised in OCI, thus offsetting (either wholly or, at least, partly) the translation difference arising on the net investment in the US subsidiary.

### Subsequent accounting

12.62 The gain or loss accumulated in equity as a result of net investment hedging is not subsequently reclassified from equity to profit or loss on a subsequent disposal (or part disposal) of the hedged foreign operation. [FRS102.12.24] This treatment is consistent with that of the exchange differences arising on the underlying hedged item, i.e. the foreign operation, since exchange differences arising on the net investment in a foreign operation are not reclassified to profit or loss on subsequent disposal of the foreign operation. [FRS102.30.13]

### Discontinuation of hedge accounting

12.63 Hedge accounting is discontinued if:

- the hedging instrument expires, is sold, exercised or terminated (e.g. an entity closes out an interest rate swap previously used for hedging interest rate risk);
- the hedge no longer meets the conditions for hedge accounting in FRS 102.12.18 (see paragraph 12.21 of this publication) (e.g. a forecast transaction is no longer highly probable); or
- the entity revokes the designation, i.e. hedge accounting is discontinued voluntarily. [FRS102.12.25]

Whatever the reason for terminating the hedge, hedge accounting is discontinued prospectively. [FRS102.12.25]

12.64 The accounting on termination of hedge accounting is summarised in the table below.

Fair value hedge	Any previous adjustment to the carrying amount of a financial instrument is amortised to profit or loss by calculating an adjusted effective interest rate. [FRS102.12.22, 25A]
Cash flow hedge – forecast transaction no longer expected to occur	The amount accumulated in the cash flow hedge reserve is reclassified immediately to profit or loss. [FRS102.12.25A]
Cash flow hedge – forecast transaction still expected to occur (even if no longer highly probable)	The amount accumulated in the cash flow hedge reserve remains in the cash flow hedge reserve and is subsequently reclassified. [FRS102.12.23(d), 25A]
Net investment hedge	The amount previously accumulated in equity is not reclassified to profit or loss. [FRS102.12.24]

## Presentation

12.65 Financial assets and financial liabilities are offset, and a net amount is presented in the balance sheet, if and only if both of the following conditions are met:

- the entity currently has a legally enforceable right to offset the recognised amounts; and
- the entity has the intention to settle on a net basis or to realise the asset and settle the liability simultaneously. [FRS102.12.25A]

Refer to Chapter 11 of this publication for further guidance on offsetting financial assets and financial liabilities.

## Disclosures

12.66 The disclosure requirements included within Section 11 apply equally to financial instruments within the scope of Section 12. Furthermore, Section 12 includes additional disclosure requirements for entities that use hedge accounting. [FRS102.12.26]

12.67 Qualifying entities applying FRS 102 (other than those that are financial institutions, as defined in paragraph 1.39 of this publication) that meet specified criteria are exempt from certain of these disclosure requirements. See paragraph 3.8 of this publication.

12.68 Additional disclosures are required to be given by financial institutions under Section 34. See Chapter 34D of this publication.

## Transition

12.69 Specific exemptions relating to hedge accounting are available on first-time adoption of FRS 102, as further discussed in paragraphs 35.26 to 35.29 of this publication.

12.70 On transition to FRS 102, an entity has the choice of whether it wishes to apply hedge accounting under FRS 102 provided the relevant Section 12 conditions for hedge accounting are met. This choice applies separately to each individual hedge relationship.

12.71 Apart from the documentation requirements, all hedge accounting criteria must be met at the date of transition to FRS 102 (or at the date the hedge relationship commences, if later). The transitional rules for first-time adopters of FRS 102 clarify that the relevant hedge documentation needs to be in place only by the date the first FRS 102 financial statements are authorised for issue.

12.72 The same transitional relief applies to entities taking the accounting policy choice under FRS 102 to follow the IAS 39 or IFRS 9 rules for financial instruments.

### vs previous UK GAAP – FRS 26 adopters

Applicable standards: FRS 25, FRS 26, FRS 29, UITF 42, UITF 46

pUK12.1 FRS 26 adopters should refer to the ‘vs EU-IFRS’ section as the requirements of FRS 26 are almost identical to those of IAS 39. FRS 26 is mandatory for entities listed on an EU-regulated market and those applying the fair value accounting rules of the Companies Act.

### vs previous UK GAAP – non-FRS 26 adopters

Applicable standards: SSAP 20, FRS 4, FRS 12, FRS 13, FRS 25, UITF 11

pUK12.2 The accounting for derivatives under previous UK GAAP depends on whether or not they are used for hedging. There is little formal guidance on hedge accounting for non-FRS 26 adopters. For example, there are no specific requirements for hedge documentation or hedge effectiveness but the derivative must eliminate or reduce risk from potential movements in interest rates, exchange rates and/or market price inherent in the assets, liabilities or cash flows being hedged. In practice, derivatives entered into for hedging purposes are typically accounted for on the same basis as the hedged asset, liability or cash flow. An example of such ‘synthetic accounting’ is that of a floating rate loan that is hedged with an interest rate swap, when the combination is accounted for as a ‘synthetic’ fixed rate loan. Further, SSAP 20 states specifically that contracted foreign exchange rates can be used to measure trading transactions in foreign currency (see also Section 30 *Foreign currency translation*).

pUK12.3 The accounting for derivatives that are not used for hedging is governed by the Companies Act and FRS 12. The initial payment for these derivatives is often nil, so under historical cost accounting rules nothing is recognised on balance sheet unless the derivative meets the definition of an onerous contract under FRS 12 and a corresponding provision is recognised.

pUK12.4 The Companies Act permits banks and insurance companies to value trading book derivatives that are transferable securities at net realisable value (even if the latter exceeds cost), allowing them in effect to fair value financial instruments through profit or loss without applying the fair value accounting rules of the Companies Act. This means they would not be required to adopt FRS 26.

pUK12.5 Net investment hedging under FRS 102 can be applied only on consolidation (except for foreign currency branches) whereas under SSAP 20 the ‘cover concept’ may also be applied in individual accounts. Thus, under SSAP 20 when the company has used foreign currency borrowings to finance a foreign currency equity investment and hedge the exchange risk, the foreign exchange movements on both the foreign currency loan and the equity investment can be recognised through the statement of total recognised gains and losses, subject to certain conditions.

pUK12.6 The former British Banking Association Statement of Recommended Practice (BBA SORP) can be referred to for further guidance as to what was recommended practice for UK banks under previous UK GAAP.

### vs EU-IFRS

Applicable standards: IAS 32, IAS 39, IFRS 7, IFRS 9, IFRIC 9, IFRIC 16, IFRIC 19

#### Hedge accounting vs IAS 39

IFRS12.1 IAS 39 uses the same hedge accounting models as FRS 102 (fair value hedge, cash flow hedge, net investment hedge), but has more onerous hedge documentation requirements. In addition, IAS 39 requires an entity to carry out formal effectiveness testing (both prospective and retrospective) throughout the hedge relationship. Hedge accounting is permitted only if changes in the fair value of the hedging instrument, and changes in the fair value of the hedged item attributable to the hedged risk, offset within the range of 80 to 125 percent. FRS 102 simply requires an economic relationship between the hedged item and the hedging instrument and consistency with the entity’s risk management objectives, without setting any thresholds for hedge effectiveness or requiring any formal effectiveness testing.

IFRS12.2 Certain more complex hedging strategies, such as macro-hedging, which are specifically permitted under IAS 39, are not available under FRS 102.

## vs EU-IFRS

Applicable standards: IAS 32, IAS 39, IFRS 7, IFRS 9, IFRIC 9, IFRIC 16, IFRIC 19

### Hedge accounting vs IAS 39

IFRS12.1 IAS 39 uses the same hedge accounting models as FRS 102 (fair value hedge, cash flow hedge, net investment hedge), but has more onerous hedge documentation requirements. In addition, IAS 39 requires an entity to carry out formal effectiveness testing (both prospective and retrospective) throughout the hedge relationship. Hedge accounting is permitted only if changes in the fair value of the hedging instrument, and changes in the fair value of the hedged item attributable to the hedged risk, offset within the range of 80 to 125 percent. FRS 102 simply requires an economic relationship between the hedged item and the hedging instrument and consistency with the entity's risk management objectives, without setting any thresholds for hedge effectiveness or requiring any formal effectiveness testing.

IFRS12.2 Certain more complex hedging strategies, such as macro-hedging, which are specifically permitted under IAS 39, are not available under FRS 102.

### Hedge accounting vs IFRS 9

IFRS12.3 IFRS 9 uses the same hedge accounting models (fair value hedge, cash flow hedge, net investment hedge) as IAS 39 and FRS 102. Like FRS 102, its aim is to align hedge accounting with an entity's risk management activities. However, IFRS 9 goes beyond the requirements of FRS 102 by introducing the concept of a hedge ratio between the hedged item and the hedging instrument. That hedge ratio may need to be rebalanced during the life of the hedge to maintain alignment with the entity's risk management objectives. Further, IFRS 9 prohibits entities from voluntarily terminating hedge accounting for relationships that remain consistent with the risk management objectives.

IFRS12.4 The FRS 102 hedge documentation requirements are based on IFRS 9 but have been simplified further. For example, unlike FRS 102, IFRS 9 includes a formal requirement to measure and document hedge ineffectiveness whilst FRS 102 only requires areas of possible hedge ineffectiveness to be identified.

IFRS12.5 IFRS 9, as currently issued, does not deal with macro-hedging. Instead, the IASB will address this under a separate project, renamed 'dynamic risk management'. Until the completion of that project, entities that have adopted IFRS 9 can continue to use the macro-hedging provisions in IAS 39.

### Recognition and measurement

IFRS12.6 See paragraphs IFRS11.1 to IFRS11.12 of this publication.

### Presentation

IFRS12.7 See paragraph IFRS11.13 of this publication.

### Disclosures

IFRS12.8 The IFRS 7 disclosure requirements for financial instruments apply to all entities using EU-IFRS. The extent of disclosures required by FRS 102 is significantly less than those required by IFRS 7.



# 13 Inventories

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## OVERVIEW OF REQUIREMENTS

- This section applies to all inventories other than work in progress for construction contracts, financial instruments, biological assets relating to agricultural activity, and produce at the point of harvest.
  - This section does not apply to the measurement of inventories measured at fair value less costs to sell through profit or loss at each reporting date.
  - Inventories are generally measured at the lower of cost and estimated selling price less costs to complete and sell.
  - Cost includes all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
  - When inventories are purchased on deferred settlement terms, any finance element of the cost is recognised as interest expense over the period of financing, unless the inventory is a qualifying asset and the entity has a policy of capitalising borrowing costs.
  - When inventories are not interchangeable they are measured by identifying individual costs. For other inventories the first-in, first-out method or weighted average cost formula is used to measure cost. The last-in, first-out (LIFO) method is prohibited.
  - Inventories are assessed for impairment at the end of each reporting date in line with Section 27 *Impairment of assets*.
  - Inventories are recognised as an expense in the period in which the related revenue is recognised.
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## FRS 102

### Section 13

13.1 Inventories are assets:

- (a) held for sale in the ordinary course of business;
- (b) in the process of production for such sale; or
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. [FRS102.13.1]

Inventory includes items that are held for distribution at no or nominal consideration, e.g. samples [FRS102.13.20A, FRS102.18.8C]

13.2 This section applies to all inventories, except:

- (a) work in progress arising under construction contracts, including directly related service contracts – see Section 23 *Revenue*;
- (b) financial instruments – see Section 11 *Basic financial instruments* and Section 12 *Other financial instruments issues*; and
- (c) biological assets related to agricultural activity and agricultural produce at the point of harvest – see Section 34 *Specialised activities*. [FRS102.13.2]

13.3 This section does not apply to the measurement of inventories that are measured at fair value less costs to sell through profit or loss at each reporting date. [FRS102.13.3]

#### Recognition of inventories

13.4 Inventory is recognised only if it meets the definition of an asset, i.e. it must be controlled by the entity and it must be probable that future economic benefits associated with it will flow to the entity. [FRS102.GL, 102.2.15, 37] This is likely to be most relevant when considering the application of new UK GAAP to, for example, consignment stock. Consignment stock consists of items owned by an entity that are held at another entity's premises and that are included as inventories of the consignor. Items held on consignment on behalf of another entity are not included in inventories of the consignee. Specific guidance is included in FRS 102 in respect of inventory that is held for distribution at no or nominal consideration, such as samples (see paragraph 13.21 of this publication).

#### Measurement of inventories

13.5 Inventories are measured at the lower of cost and estimated selling price less costs to complete and sell. [FRS102.13.4] When inventories are held for distribution (for example, items to be distributed to beneficiaries by public benefit entities and promotional materials), they are measured at cost less loss of service potential. [FRS102.13.4A, FRS102.A4.36, 37] When cost includes amounts in a foreign currency, those amounts are retranslated at the spot rate on the date of the transaction. [FRS 102.30.7]

13.6 Inventory may be recognised as a result of a change in intention by the entity. For example, an entity holding investment property (see Section 16 *Investment property*) may change its intended use of a property such that the property no longer meets the definition of investment property and instead meets the definition of inventory. When such investment property is held at fair value under FRS 102.16.7, it is appropriate to consider this fair value to be the deemed cost of that inventory at initial recognition.

13.7 The cost of inventories includes all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. [FRS102.13.5] If acquired through a non-exchange transaction (i.e. an arrangement in which the transacting entities do not receive approximately equal value), inventories are measured at acquisition date fair value. [FRS102.13.5A] For public benefit entities and entities within a public benefit entity group, this applies only when incoming resources are recognised (see Section 34).

13.8 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase. [FRS102.13.6]

13.9 Measuring the amount of trade discounts and rebates to be deducted in determining cost can be complex. For example, when the period over which the discount is earned differs from the entity's reporting period, estimating the cost of inventory purchased at the balance sheet date may require judgement. FRS 102 does not contain specific guidance on this issue. We believe that trade discounts or similar rebates should be recognised as a reduction in the purchase price when it is probable that the discounts or rebates will be earned and their amounts can be estimated reliably. If an entity changes its estimate of the cost of an item of inventory already purchased and sold, for example because its estimate of the amount of a discount changes, then the effect of the change is recognised in the income statement, generally in cost of sales.

13.10 When inventories are purchased on deferred settlement terms, any finance element is recognised as interest expense over the period of financing. It is not part of the cost of the inventories unless the inventory is a qualifying asset (see Section 25 *Borrowing costs*) and the entity adopts a policy of capitalisation of borrowing costs. [FRS102.13.7]

13.11 The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour. When a process leads to the production of more than one product (for example, some chemical processes or oil refining), costs are allocated to each material product. [FRS102.13.8, FRS102.13.10]

13.12 Other costs are included only to the extent that they are incurred in bringing the inventories to their present location and condition. [FRS102.13.11]

13.13 An entity may hedge the commodity price risk present in inventory held on balance sheet or in a firm commitment to purchase inventory. As further explained in paragraph 12.45 of this publication, the carrying amount of the related inventory is adjusted for the effect of the hedge ('basis adjustment'). [FRS102.12.20]

13.14 Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred include:

- (a) abnormal amounts of wasted materials, labour or other production costs;
- (b) storage costs, unless those costs are necessary during the production process before a further production stage;
- (c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and
- (d) selling costs. [FRS102.13.13]

13.15 In our view, only rarely will storage costs be included in the cost of inventory because they are generally not necessary in bringing the inventory to its current location and condition. Examples of storage costs that may be necessary in bringing the inventory to its current location and condition include the maturing or refining process of some alcoholic drinks.

13.16 In some cases the costs of inventories may be approximated using techniques such as:

- (a) standard cost – using normal levels of material, supply, labour, efficiency and capacity. The 'normal' base is reviewed regularly to reflect current conditions;
- (b) retail method – using percentage gross margin to reduce sales value; and
- (c) most recent purchase price. [FRS102.13.16]

13.17 The cost of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects is measured by using specific identification of their individual costs. [FRS102.13.17]

13.18 The first-in, first-out (FIFO) or weighted average cost formula is used to measure the cost of inventories, other than those detailed in paragraph 13.17 of this publication. The same cost formula is used for all inventories that are similar in nature or use. For inventories with a different nature or use, different cost formulas may be justified. The LIFO method is not permitted. [FRS102.13.18]

### Impairment

13.19 Inventories are assessed for impairment at each reporting date, as described in Section 27 *Impairment of assets*. An impairment is recognised when the carrying amount is not fully recoverable, for example due to damage, obsolescence or declining selling prices. When an item (or group of items) is impaired, it is measured at its selling price less costs to complete and sell and an impairment loss is recognised. A reversal of a prior impairment is required in some circumstances. [FRS102.13.19]

### Recognition as an expense

13.20 The carrying amount of inventory is recognised as an expense in the period in which the related revenue is recognised. [FRS102.13.20]

13.21 Inventory that is held for distribution at no or nominal consideration (e.g. samples) is recognised as an expense when distributed. [FRS102.13.20A]. Depending on the facts and circumstances, other items related to advertising activity, e.g. brochures and catalogues, may or may not be inventories held for distribution at no or nominal consideration. Such items will be expensed either when the related goods or services are received by the entity or when the inventory is distributed, as appropriate. [FRS102.18.8C,D]

13.22 Inventory allocated to another asset (e.g. used to construct property, plant or equipment) is then accounted for under the appropriate section of FRS 102 (e.g. Section 17 *Property, plant and equipment*). [FRS102.13.21]

### Service providers

13.23 Service providers measure their inventory at cost of production, including costs of labour and attributable overheads.

13.24 Sales and general administrative costs are recognised as expenses in the period incurred.

13.25 Profit margins and non-attributable overheads are not included in the cost of inventories although they are often included in the price to customers. [FRS102.13.14]

### Agricultural produce

13.26 See Section 34 for guidance on agricultural produce harvested from biological assets. This is measured initially, at the point of harvest, either at fair value less costs to sell or the lower of cost and estimated selling price less costs to sell. This becomes the cost of the inventories at that date for the application of this section. [FRS102.13.15]

### Transition

13.27 No exemption is available from retrospective application of the requirements of this section of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

## vs previous UK GAAP

### Applicable standards: SSAP 9

pUK13.1 Whilst SSAP 9 refers to 'net realisable value' rather than 'estimated selling price less costs to complete and sell' this is a difference only in terminology. The definition of net realisable value sets out that it is the selling price less costs to complete and marketing, selling and distribution costs yet to be incurred.

pUK13.2 The use of LIFO is not prohibited but is extremely rare in practice.

pUK13.3 There are no special measurement rules for agricultural or mineral inventories.

## vs EU-IFRS

### Applicable standards: IAS 2

IFRS13.1 IAS 2 refers to 'net realisable value' rather than 'estimated selling price less costs to complete and sell'. However, the way that net realisable value is defined in IAS 2.6 means this is not a measurement difference in practice.

IFRS13.2 IAS 38.69(c) requires that expenditure on advertising and promotional activities (including mail order catalogues) is expensed when the benefit of those goods or services is available to the entity.

IFRS13.3 The inclusion of borrowing costs in the cost of inventories is required in certain circumstances.



# 14 Associates

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## OVERVIEW OF REQUIREMENTS

- An associate is an entity over which an investor has significant influence but which is not a subsidiary or a joint venture.
  - In consolidated financial statements, associates are accounted for using the equity method unless they are part of an investment portfolio.
  - In individual financial statements, a policy choice is available to account for interests in associates either at cost less impairment, at fair value with movements above/below cost recognised through other comprehensive income/profit or loss respectively, or at fair value with changes in fair value recognised in profit or loss.
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## FRS 102

### Section 14

#### Associates

14.1 An associate is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. [FRS102.14.2]

14.2 Significant influence is the power to participate in the financial and operating policy decisions of the associate but is not control or joint control over those policies. [FRS102.14.3]

14.3 Significant influence is presumed to exist when the investor holds, directly or indirectly, 20 percent or more of the voting power of the associate. Conversely, if less than 20 percent is held, it is presumed that the investor does not have significant influence. Each of these presumptions is overturned if it can be clearly demonstrated not to be the case. Examples of ways that significant influence might be evidenced include representation on the board, participation in policy making, or the right of veto for certain transactions or policies. The fact that another investor holds a substantial or majority interest does not preclude an investor from having significant influence. [FRS102.14.3]

#### Example 14.1

##### Significant influence

Company C owns 10% of Company D and is entitled to one seat on the board. The remaining 90% of D is owned by Company E, which appoints the remaining four directors on the board. Does C have significant influence over D?

As C has a seat on the board it is able to participate in the financial and operating decisions of D. As such, C has significant influence over D.

#### Measurement

##### Individual financial statements

14.4 In its individual financial statements (see paragraph 9.41 of this publication) an investor has an accounting policy choice (applying paragraphs FRS 102.9.26 and FRS 102.9.26A) between measuring investments in associates at:

- cost less impairment (assessed in accordance with Section 27 *Impairment of assets*; [FRS102.14.5]) or
- fair value with movements recognised in other comprehensive income (OCI) while the fair value of the investment remains above cost, and in profit or loss if fair value is less than cost (see paragraph 17.24 of this publication); or
- fair value through profit or loss. [FRS102.14.4]

14.5 This choice is available whether or not the investor is also a parent, i.e. also has subsidiaries. For guidance on fair value see paragraph 11.90 of this publication. [FRS102.14.1,4]

14.6 Dividends and other distributions received from associates are recognised as income. This applies whether they are paid from pre- or post-acquisition accumulated profits of the associate. [FRS102.14.6,10A]

14.7 An investor that is measuring an associate at fair value remeasures its investment to fair value at each reporting date. The cost model is used by an investor otherwise applying the fair value model when it is impracticable to measure fair value reliably without undue cost or effort. [FRS102.14.10]

##### Consolidated financial statements

14.8 In its consolidated financial statements, an investor accounts for its investments in associates using the equity method unless they are part of an investment portfolio (see paragraph 14.9 of this publication). [FRS102.14.4A]

##### Associates held as part of an investment portfolio

14.9 In consolidated financial statements, associates held as part of an investment portfolio are measured at fair value with changes in fair value recognised in profit or loss, rather than being accounted for using the equity method. An associate is held as part of an investment portfolio if it is part of a basket of investments that is held (directly or indirectly) to benefit from changes in its fair value, rather than as a vehicle through which the investor carries out business activities. When an investment fund holds an investment in another fund which itself holds a basket of investments, that basket of investments is said to be held indirectly. [FRS102.14.4B]

## Equity method

14.10 The equity accounting model in FRS 102 recognises a 'share of profit' on a post-tax basis, disclosed on a single line in the income statement. [Regulations Sch1, Part1, Section B]

14.11 Under the equity method of accounting, the investment is recognised initially at the transaction price (including transaction costs). [FRS102.14.8] It is subsequently adjusted to reflect:

- (a) *The investor's share of the profit or loss, other comprehensive income and equity of the associate.* Note that the share of profit or loss is the share of the post-tax result of the associate from the bottom line of its income statement. Unless impractical to do so, this is taken from the financial statements of the associate prepared to the same date as those of the investor and adjusted to reflect the investor's accounting policies. Otherwise, the most recent financial statements of the associate are used, adjusted for significant transactions between its period end and that of the investor. The investor's share of profit or loss and OCI and share of changes in equity are measured on the basis of present ownership interest; the possible exercise or conversion of potential voting rights is not taken into account.

### Example 14.2

#### Voting power vs profit share

A holds 30% of the votes in B, but is entitled to 40% of its profits and net assets. In our view, B should equity account for a 40% interest in B, because equity accounting is described with reference to the investor's share in net assets and profit or loss.

### Example 14.3

#### Indirect holding

Company A owns 80% of Company B. B owns 30% of its associate, Company C.

A's consolidated financial statements, which report the group composed of A and B, will record 30% of C's profit (through the line-by-line consolidation of B [FRS102.9.13(a)]) as the group's share of the result of its equity-accounted investment. Within equity, 20% of A's share of the profit of C (i.e. 20% of 30% of C's profit) is allocated to NCI. [FRS102.9.13(c)]

- (b) *Distributions received* reduce the carrying amount of the investment.
- (c) *Implicit goodwill and fair value adjustments.* On acquisition, any difference (positive or negative) between the cost of acquisition and the investor's share of the fair values of the net identifiable assets of the associate is accounted for as goodwill or negative goodwill in accordance with Section 19 *Business combinations and goodwill*. [FRS102.19.22-24] The investor's share of the associate's profits or losses recognised after acquisition is adjusted to take account of any additional amortisation of goodwill or depreciation and amortisation of fair value adjustments.



**Example 14.4****Acquisition of an associate**

A acquired a 30% interest in B for £200 in cash on 31 December 2013. The book value (BV) and fair value (FV) of the net assets of B at acquisition and the goodwill arising on acquisition were as follows:

	A's share at FV £
Property, plant & equipment (PP&E) (B's BV + 15)	45
Inventory (B's BV + 30)	90
Other net assets (B's BV)	30
<b>Net assets acquired</b>	<b>165</b>
Goodwill on acquisition	35
<b>Consideration - cash</b>	<b>200</b>

PP&E has a remaining useful life of 3 years. Goodwill has a useful life of 5 years. The inventory is sold in February 2014. In its own books, B reports a profit of 400 in 2014 (A's 30% share = 160).

	£	£
A's investment in B at 31 December 2013		200
A's share of B's 2014 profit before adjustments	160	
Goodwill amortisation (35/5 years)	(7)	
Additional PP&E depreciation (15/3 years)	(5)	
Inventory adjustment (full amount sold in 2014)	(30)	
<b>A's revised share of B's profit</b>		<b>118</b>
<b>A's investment in B at 31 December 2014</b>		<b>318</b>

- (d) *Impairment.* When an indicator of impairment exists the entire carrying amount of the investment (including any related goodwill) is tested for impairment as a single asset in accordance with Section 27. Any impairment is allocated to the underlying assets of the associate.
- (e) *Investor's transactions with associates.* Profits or losses resulting from upstream (associate to investor) and downstream (investor to associate) transactions are eliminated to the extent of the investor's interest in the associate. Losses on such transactions may provide evidence of an impairment of any asset transferred.
- (f) *Recognition of losses in the associate.* When the investor's share of losses of an associate equals or exceeds the carrying amount of its investment, the investor stops recognising its share of further losses. Once the investment is reduced to zero, the investor recognises additional losses as a provision in accordance with Section 21 *Provisions and contingencies* only to the extent that the investor has incurred legal or constructive obligations or has made payments on behalf of the associate. The investor recognises its share of any subsequent profits only after its share of profits equals its share of losses not recognised.

**Example 14.5****Recognition of losses when investment falls below zero**

Company A is an associate of Company B. B's investment in A at 31 December 20X3 was 300 in its consolidated accounts. B's share of A's loss for the year to 31 December 20X4 was 500. B has no legal or constructive obligation to fund any losses made by A. In its consolidated accounts at 31 December 20X4 B records a loss of 300 and an equity-accounted investment of nil in relation to A.

Subsequently, B's share of A's profit for the year ended 31 December 20X5 was 400. B recognises its share of equity-accounted associate profit of 200 (being its share of the profit of 400 less previously unrecorded losses of 200) and an equity-accounted investment of 200 in its 31 December 20X5 consolidated accounts.

14.12 An entity may contribute a business or other non-monetary asset in return for an interest in an associate. To the extent that it retains an interest in the business or asset contributed, that interest is treated as if it has continued to be owned by the entity throughout the transaction and is included at its pre-transaction carrying amount. The consideration given for the interest acquired includes the fair value of the part of the business or non-monetary asset contributed that is no longer held. Goodwill is computed on the acquired interest as the difference between the fair value of the consideration given and the fair value of the entity's share of the net assets of the other entity that have been acquired. Paragraph 15.18 of this publication illustrates how goodwill is computed in this situation. [FRS102.9.31]

**Discontinuing the equity method**

14.13 An investor stops using the equity method from the date that it ceases to have significant influence over its former associate. [FRS102.14.8(i)]

14.14 If an associate becomes a subsidiary, the investor derecognises its equity-accounted investment on the date that it gains control and applies Section 19, save for the calculation of goodwill. This is illustrated in paragraph 19.26 of this publication. Briefly put, goodwill is recorded on the date that control is gained by adding together the goodwill arising on each tranche purchased. It is calculated as the difference between the cost of that tranche and the fair value (at the date of original purchase) of the identifiable assets and liabilities attributable to the tranche. In other words, the goodwill underlying the existing associate stake is not revalued (in a separate step the identifiable net assets are, however, revalued). Legal Appendix 4.17 to FRS 102 explains that this is an instance of the true and fair override (see paragraph 3.56 of this publication).

14.15 If significant influence is lost as a result of the investor disposing of some or all of its investment ('a full or partial disposal'), a profit or loss will arise. This is comprised of two elements: first, the difference between the proceeds received and the proportionate share of the carrying amount of the investment that is disposed of; and, second, any amounts previously recognised in OCI in relation to the associate that are required by other sections of the standard to be recycled to profit or loss on disposal. Amounts recognised in OCI in relation to the associate that are not required to be recycled are instead transferred within equity directly to retained earnings, if they were recognised originally in a different component of equity.

14.16 The proportion of the carrying value retained is treated as the cost of any interest retained. Subsequently, any retained interest is accounted for using Section 11 *Basic financial instruments* or Section 12 *Other financial instruments issues* as appropriate. Section 12 will, in many cases, require the retained interest to be carried at fair value with movements recorded in profit or loss. Similarly, Section 11 may require certain retained interests to be measured at fair value. To the extent that there is a difference between the fair value of the retained interest and the proportionate share of the book value retained, an immediate gain or loss will arise.

**Example 14.6****Partial disposal of investment in an associate**

P acquired a 25% stake in S in 2012 for 200. P accounted for S as an associate. In 2013 P recorded equity-accounted profits of 30 and recorded a loss of 20 in the cash flow hedge reserve. At 1 January 2014 its interest in S was therefore recorded as 210.

On 1 January 2014 P disposed of part of its investment for 205, retaining only a 5% stake with a fair value of 40. P records the following in its consolidated accounts.

	Dr £	Cr £
Cash	205	
Financial asset investment	40	
Gain on disposal of associate		15
Cash flow hedge reserve		20
Equity-accounted investment		210

Although the remaining financial asset is required to be measured initially at cost, being the proportion of the carrying value retained ( $190/25\% \times 5\% = 38$ ), it is then required by Section 11 to be remeasured immediately to fair value. The net gain on disposal is therefore calculated as the difference between the cash paid (205), plus the fair value of the retained interest (40), less the book value of the previously held investment (210), less the recycled cash flow hedge reserve.

However, in contrast to the recycling of the cash flow hedge reserve, in accordance with FRS 102.30.13, any amounts that might have been recorded in OCI in relation to translation of a foreign operation are not recognised in profit or loss on disposal of the net investment

14.17 If an investor loses significant influence for other reasons (i.e. other than having disposed of some or all of its investment) the carrying amount of the investment at that date is regarded as the cost of the retained interest which is accounted for using Section 11 or 12, as appropriate. Similar to paragraph 14.16 above, the application of Section 11 or 12 may result in an immediate gain.

### Transition

14.18 An exemption from retrospective application on first-time adoption of FRS 102 of certain requirements of this section of the standard is available, as discussed in paragraph 35.23 of this publication.

## vs previous UK GAAP

## Applicable standards: FRS 9, UITF 31

**Associates**

pUK14.1 For an associate relationship to exist, the definition of an associate in FRS 9 requires that an investor holds a participating interest and actually exercises significant influence over an investee.

pUK14.2 Under FRS 9, in individual financial statements, investments in associates are shown either at cost less impairment, or at a valuation. Movements in the valuation are recognised in reserves unless they are downward revaluations below depreciated historical cost (but above recoverable amount) or represent a clear consumption of economic benefits. In such cases they are recognised in profit or loss; fair value through profit or loss is not an available policy choice.

pUK14.3 Under previous UK GAAP, in individual financial statements, to the extent that a dividend from an investment reduces its value below its carrying amount, it is a return of investment rather than income. That portion of the dividend is therefore credited directly against the carrying amount of the investment rather than being recorded in profit or loss together with an impairment.

**Equity accounting**

pUK14.4 Under both FRS 9 and FRS 102, an investor adjusts its share of the profits and losses of an associate for the effects of implicit goodwill and fair value adjustments (for example, by recognising additional amortisation and depreciation). Differences may arise because of the different requirements for acquisition accounting (see Chapter 19 of this publication) and because of different requirements for amortisation and depreciation. For example, goodwill arising on the acquisition of an investment in an associate is typically amortised over no more than 20 years under FRS 10; FRS 102 introduces a presumption that its life does not exceed five years<sup>1</sup> unless a reliable estimate of its life can be made.

pUK14.5 Under FRS 9 'share of result' is included on an operating profit basis, with the investor's share of interest and tax disclosed adjacent to (interest) or as part of (tax) the respective lines of the consolidation.

pUK14.6 Under FRS 102, a share of net liabilities/losses of an associate is recognised only if it meets the definition of a provision. Under FRS 9, the share of net liabilities is recognised unless there is sufficient evidence that the relationship between the investor and its investee has changed irrevocably, marking the investor's irreversible withdrawal from the investee as its associate, for example, by making a public statement of withdrawal. It is therefore less likely that a provision will be recognised for net liabilities of associates under FRS 102.

**Investment funds**

pUK14.7 Under FRS 9, investment funds, such as those in the venture capital and investment trust industries, have the choice of measuring all investments in their investment portfolio (including those over which they have significant influence) either at cost or at market value, as long as they are all measured on the same basis. Under FRS 102, associates held as part of an investment portfolio are measured at fair value through profit or loss.

1. The maximum period is ten years for periods beginning on or after 1 January 2016 (or earlier adoption of the July 2015 amendments to FRS 102 – see paragraph INT. 6 of this publication). The July 2015 amendments to FRS 102 also clarify that an inability to make a reliable estimate of the useful life of goodwill is expected to arise only in exceptional cases.

## vs EU-IFRS

### Applicable standards: IAS 28, SIC-13

IFRS14.1 Under both EU-IFRS and FRS 102, an investor adjusts its share of the profits and losses of an associate for the effects of implicit goodwill and fair value adjustments (for example, by recognising additional amortisation and depreciation). Differences between EU-IFRS and FRS 102 may arise because of the different requirements for acquisition accounting (see Chapter 19 of this publication) and because of different requirements for amortisation and depreciation. For example, goodwill arising on the acquisition of an investment in an associate is not amortised under EU-IFRS.

IFRS14.2 Under EU-IFRS, when an investor gains control of an investment over which it previously had significant influence, the retained investment is remeasured to fair value. In contrast, under FRS 102.19.11A the investment is not remeasured on gaining control.

IFRS14.3 Under EU-IFRS, when an investor loses significant influence and retains only an investment, that investment is remeasured to fair value. In contrast, FRS 102.14.8(i)(i) considers the carrying amount of the investment at the date that significant influence was lost as its cost. However, this apparent difference may not be as significant as it first appears because FRS 102 will, in many cases, require the retained interest to be recorded as a financial instrument at fair value through profit or loss.

IFRS14.4 Under EU-IFRS, an optional exemption from equity accounting exists for investments in associates held by venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds that, upon initial recognition, are designated as at fair value through profit or loss. The equivalent exemption in FRS 102 applies to associates held as part of an investment portfolio and is mandatory.

# 15 Joint ventures

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## OVERVIEW OF REQUIREMENTS

- A joint venture is a contractual arrangement between two or more parties to carry out an economic activity under joint control.
  - If a joint venture is carried out through an entity, it is treated as a Jointly Controlled Entity (JCE).
  - In consolidated financial statements JCEs are accounted for using the equity method.
  - In individual financial statements a policy choice is available to account for interests in JCEs either at cost less impairment, at fair value with movements above/below cost recognised through other comprehensive income/profit or loss respectively, or at fair value with changes in fair value recognised in profit or loss.
  - If a joint venture is not carried out through a separate entity, then it is treated as either a Jointly Controlled Asset (JCA) or a Jointly Controlled Operation (JCO).
  - In respect of JCAs and JCOs, a venturer records in its own (i.e. individual financial statements) balance sheet the assets that it controls and the liabilities that it incurs, along with its share of any jointly controlled assets or jointly incurred liabilities. In its own profit and loss account, a venturer records its income from selling its share of the joint venture's output, the expenses that it has incurred in respect of the joint venture, and its share of any income earned or expenses incurred by the joint venture.
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## FRS 102

### Section 15

#### Joint ventures

15.1 A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. Joint ventures can take the form of JCOs, JCAs, or JCEs. [FRS102.15.3]

15.2 Joint control is the contractually-agreed sharing of control (see paragraphs 9.14 to 9.18 of this publication) over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers). [FRS102.15.2]

#### Example 15.1

##### Joint control

A company has 3 shareholders A, B and C, each holding one third of the shares. Strategic decisions require a majority vote to be passed. In this case the shareholders do not have joint control because strategic decisions do not require the unanimous consent of the shareholders.

If a contract was entered into so that Board decisions required the consent of both A and B, but not C, then A and B would have joint control. C would not have joint control and would account for its investment as an associate if it met the conditions in Section 14 *Investments in associates*, or a financial asset in accordance with Section 11 *Basic financial instruments*.

#### Jointly controlled operations (JCOs)

15.3 JCOs involve the use of assets and resources of the venturers rather than the establishment of a separate entity or a financial structure separate from the venturers themselves. Each venturer uses its own assets, incurs its own expenses and liabilities, and raises its own finance. The JCO's activities may be carried out by the venturer's employees alongside its other business activities. The joint venture agreement will normally include a means by which revenue from the joint venture and any common expenses incurred are shared among the venturers. [FRS102.15.4]

15.4 JCOs are accounted for in the venturer's individual financial statements (and hence in its consolidated financial statements) by the venturer recognising:

- (a) the assets that it controls and the liabilities that it incurs; and
- (b) the expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture. [FRS102.15.5]

#### Example 15.2

##### JCO

Company A prints hard copy children's books and company B produces audiobooks. A and B enter into an agreement to produce sets containing a printed book and a recording. All decisions about the sale of the sets require the unanimous consent of A and B. A will manufacture the book and bear the cost of doing so, and B will manufacture the recording and bear the cost of doing so. According to the agreement A and B will split the revenue from the sale of the sets 50:50. Each will therefore record 50% of the revenue in their own individual financial statements, along with their own costs.

#### Jointly controlled assets (JCAs)

15.5 JCAs involve the joint control, and/or joint ownership, of one or more assets acquired for the joint venture and dedicated to the purposes of the joint venture. [FRS102.15.6]

15.6 JCAs are accounted for by the venturer recognising in its individual (and consolidated) financial statements:

- (a) its share of each of the jointly controlled assets;
- (b) any liabilities that it has incurred;
- (c) its share of each of any liabilities incurred jointly with the other venturers in relation to the joint venture;

- (d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and
- (e) any expenses that it has incurred in respect of its interest in the joint venture. [FRS102.15.7]

### Example 15.3

#### JCA

Companies A and B agree to construct and operate a pipeline. All decisions about the pipeline are taken unanimously by A and B. Each company uses the pipeline to transport its own oil and the cost of the asset is split 50:50 between the two companies. Both therefore record 50% of the pipeline and its operating costs in their own individual financial statements.

### Jointly controlled entities (JCEs)

15.7 A JCE is a joint venture that involves the establishment of a company, partnership or other entity in which each venturer has an interest. [FRS102.15.8]

### Example 15.4

#### JCE

Companies A and B create a separate legal entity to build a superstore. All decisions about the entity require the unanimous consent of A and B. All assets are acquired in the name of the new entity and all sales and purchases will be effected by the new entity. A and B will equity account for their interests in the jointly controlled entity in their consolidated financial statements.

### Measurement – individual financial statements

15.8 In its individual financial statements, FRS 102.9.25-26 give a venturer an accounting policy choice between measuring interests in JCEs at cost less any accumulated impairment losses recognised in accordance with Section 27 *Impairment of assets*, at fair value under the fair value model (see next paragraph), or at fair value through profit or loss (see paragraph 11.90 of this publication for guidance on fair value). [FRS102.15.1,9] This choice is available whether or not the investor is also a parent, i.e. also has subsidiaries.

#### Fair value model

15.9 Under the fair value model, at each reporting date the JCE is remeasured to fair value. Changes in fair value are recognised in accordance with paragraph 17.23 of this publication, i.e. through other comprehensive income so long as fair value is above cost and through profit or loss when fair value is below cost. The cost model is used by an investor otherwise applying the fair value model when it is impracticable to measure fair value reliably without undue cost or effort. [FRS102.15.15]

15.10 Dividends and other distributions received from the JCE are recognised as income, regardless of whether distributions paid are from pre- or post-acquisition accumulated profits of the JCE. [FRS102.15.11,15A]

### Measurement – consolidated financial statements

15.11 In its consolidated financial statements, a venturer accounts for its investments in JCEs using the equity method, unless they are part of an investment portfolio (see below). [FRS102.15.9A] The accounting for a JCE using the equity method is the same as that for an associate, as set out in paragraph 14.10 of this publication. [FRS102.15.13]

15.12 In consolidated financial statements, JCEs held as part of an investment portfolio are measured at fair value with changes in fair value recognised in profit or loss, rather than being accounted for using the equity method. [FRS102.15.9B] A JCE is held as part of an investment portfolio if it is part of a basket of investments that is held (directly or indirectly) to benefit from changes in its fair value, rather than as a vehicle through which the investor carries out business activities. When an investment fund holds an investment in another fund, which itself holds a basket of investments, that basket of investments is said to be held indirectly.

15.13 An investor in a joint venture that does not have joint control accounts for that investment in accordance with Section 11 or Section 12 *Other financial instruments issues* or, if it has significant influence in the joint venture, in accordance with Section 14. [FRS102.15.18]



### Loss of joint control

15.14 An investor accounts for the loss of joint control over a JCE as for the loss of significant influence over an associate, as set out in paragraphs 14.13 to 14.17 of this publication, substituting 'joint control' for 'significant influence'. [FRS102.15.13]

### Transactions between a venturer and a joint venture

15.16 When a venturer contributes or sells assets to a joint venture, it recognises only the portion of the gain or loss attributable to the interests of the other venturers. However, if the sale or contribution provides evidence of an impairment loss then that loss is recognised by the venturer. [FRS102.15.16]

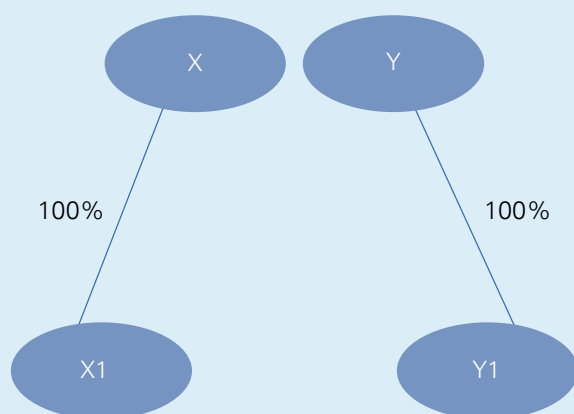
15.17 When a venturer purchases assets from a joint venture, the venturer does not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party. FRS 102 does not specify what it means by 'independent party'. [FRS102.15.17]

15.18 An entity may contribute a business or other non-monetary asset in return for an interest in a joint venture. To the extent that it retains an interest in the business or asset contributed, that interest is treated as if it has continued to be owned by the entity throughout the transaction and is included at its pre-transaction carrying amount. The consideration given for the interest acquired includes the fair value of the part of the business or non-monetary asset contributed that is no longer held. Goodwill is computed on the acquired interest as the difference between the fair value of the consideration given and the fair value of the entity's share of the net assets of the other entity that have been acquired. [FRS102.9.31]

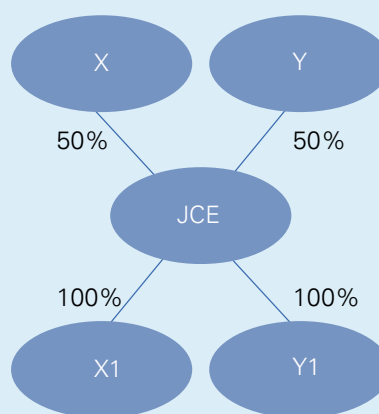
#### Example 15.5

Entities X and Y contribute their subsidiaries X1 and Y1 to a newly-formed JCE. In return, they each obtain a 50% stake in the JCE.

Before contribution of subsidiaries to JCE:



After contribution of subsidiaries to JCE:



Before the transaction, the book value of X1's net assets in X's consolidated accounts is 100. The fair value of X1 is 150.

X continues to carry the 50% interest in X1 that it effectively retains at its pre-transaction carrying amount of 50 (i.e. 50% x 100). In addition, it obtains 50% of Y1 for consideration of 50% of the fair value of X1, being 75 (50% x 150). It therefore records that 50% of Y1 at 75 and computes goodwill based on the difference between 75 and 50% of the fair value of Y1's identifiable net assets. X's investment in the new JCE is therefore recorded at a total of 125 (50 + 75) and it records a gain of 25 on the disposal of 50% of X1 (50% x (fair value of 150 – book value of 100)).

### Transition

15.19 An exemption from retrospective application on first-time adoption of FRS 102 of certain requirements of this section of the standard is available as discussed in paragraph 35.23 of this publication.

## vs previous UK GAAP

Applicable standards: FRS 9, UITF 31

### Joint ventures

pUK15.1 FRS 9 defines a joint venture as an entity subject to joint control. It is an entity in substance as well as in form, which requires it to be a stand-alone business with, for example, policy set in its own right rather than its activities being predetermined. An incorporated undertaking is not necessarily an entity when applying FRS 9.

pUK15.2 When a joint arrangement is not an entity, each party includes in its individual (and hence also in its consolidated) financial statements its share of assets, liabilities and cash flows, measured according to the terms of the arrangement.

pUK15.3 FRS 9 requires that, in consolidated financial statements, an investor includes its joint ventures using the gross equity method. Under the gross equity method, the net of the amounts reflected in the investor's financial statements is the same as that reported using the FRS 102 equity method. However, there is expanded disclosure. In particular, under the gross equity method in FRS 9:

- the investor's share of the gross assets and liabilities of equity-accounted investees is noted on the face of the balance sheet;
- the investor's share of the investees' turnover is noted on the face of the profit and loss account; and
- the 'share of result' is a share of profit after tax.

pUK15.4 Under FRS 9, in individual financial statements, investments in joint ventures are shown either at cost less impairment, or at a valuation. Movements in the valuation are recognised in reserves unless they are downward revaluations below depreciated historical cost (but above recoverable amount) or represent a clear consumption of economic benefit. In such cases they are recognised in profit or loss; fair value through profit or loss is not an available policy choice.

### Equity accounting

pUK15.5 As discussed in Chapter 14 of this publication, there are a number of differences between the mechanics of equity accounting in FRS 9 and FRS 102.

### Investment funds

pUK15.6 Under FRS 9, investment funds, such as those in the venture capital and investment trust industries, measure all investments in their investment portfolio in the same way (at cost or market value), even those over which the investor has joint control. Under FRS 102, JCEs held as part of an investment portfolio are measured at fair value through profit or loss.

## vs EU-IFRS

### Applicable standards: IFRS 11, IAS 31, SIC-13

IFRS15.1 IFRS 11 classifies joint arrangements, i.e. arrangements that are jointly controlled, as either joint ventures (when the parties have rights to the net assets of the arrangement) or joint operations (when the parties have rights to the assets and obligations for the liabilities of the arrangement). Certain joint arrangements that are structured through an entity are required to be treated as joint operations when they are set up in a way that gives the parties rights to their assets, and obligations for their liabilities.

IFRS 15.2 An arrangement classified as a JCO or JCA under FRS 102 will be classified as a joint operation under EU-IFRS (in effect preserving the FRS 102 accounting). In most, but not all, cases an arrangement classified as a JCE under FRS 102 will be classified as a joint venture under EU-IFRS (for which equity accounting in the consolidated financial statements is required).

IFRS15.3 Under EU-IFRS, an optional exemption from equity accounting exists for investments in joint ventures held by venture capital and similar organisations that, upon initial recognition, are designated as at fair value through profit or loss. The exemption is mandatory for investment entities. The equivalent exemption in FRS 102 applies to JCEs held as part of an investment portfolio (refer to Chapter 9 of this publication) and is mandatory.

IFRS15.4 In its individual financial statements, an investor has an accounting policy choice to account for investments in joint ventures either at cost or by applying IAS 39.

#### Previous requirements under IAS 31

IFRS15.5 IAS 31 was the standard for joint arrangements that was applicable prior to IFRS 11 (i.e. for EU-IFRS for years beginning before 1 January 2014). IAS 31 classified joint arrangements as either JCEs, JCAs or JCOs in a similar way to FRS 102. However, in contrast to FRS 102, IAS 31 allowed a venturer to opt to account for an interest in a JCE using proportionate consolidation in its consolidated financial statements.

# 16 Investment property

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## OVERVIEW OF REQUIREMENTS

- Investment property is land or buildings held to earn rentals, for capital appreciation, or both.
  - Investment property is measured initially at cost. Cost includes any directly attributable expenses.
  - In subsequent accounting periods, it is revalued to fair value through profit or loss, unless fair value cannot be measured reliably without undue cost or effort on an ongoing basis. In such cases, the investment property is accounted for as property, plant and equipment under Section 17 *Property, plant and equipment*.
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## FRS 102

### Section 16

#### Definition and recognition

16.1 Investment property is property (land or a building, or part of a building, or both) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for:

- (a) use in the production or supply of goods or services or for administrative purposes; or
- (b) sale in the ordinary course of business. [FRS102.16.2]

16.2 Classification as investment property is mandatory when the above definition is met. The definition includes property under construction or development for future use as an investment property and so the same classification and measurement requirements apply to these assets under construction.

16.3 In addition, the definition does not exclude properties that are let to and occupied by entities in the same group as the lessor. These would be recognised as investment properties in the individual financial statements of the lessor but not in the group financial statements.

16.4 There is a classification option, available on a property-by-property basis, for property interests held by a lessee under an operating lease to be accounted for as investment property. This can be applied when the property would otherwise meet the definition of an investment property, i.e. the leased property is held for capital appreciation or rental income, and the lessee can measure the fair value of the property interest without undue cost or effort on an ongoing basis. [FRS102.16.3]

16.5 If this classification option is taken, the lessee accounts for the lease as if it were a finance lease and recognises the leased asset at the lower of fair value and the present value of the minimum lease payments, and an equivalent liability.

#### Properties considered to be investment properties

16.6 When a property's primary purpose is the provision of social benefits e.g. social housing, it is not classed as investment property but is accounted for under Section 17 *Property, plant and equipment*. [FRS102.16.3A]

16.7 In our experience, careful consideration is often required to distinguish between properties used by the entity in the provision of services, and investment properties. Particular areas that may require careful consideration include car parks, hotels, pubs and business centres. In our view, the entity's business model (i.e. intentions regarding that property) should be the primary criterion to consider in determining whether classification as investment property is appropriate.

16.8 Similar principles would apply when considering whether properties should be considered to be investment properties, or properties held for sale and accounted for as inventory. In our view, when an entity has a credible plan to sell the property in the ordinary course of business and this is supported by that entity's business model, then its treatment as inventory would be appropriate.

16.9 There are also cases when an entity provides ancillary services to the occupants of a property, e.g. a shopping mall when the manager uses 5 percent of the property for administration of the facility together with services provided to the tenants. Facts and circumstances would dictate whether that space should be considered an integral part of the investment property (and not considered separately) or whether the mall would be considered to be a mixed use property.

16.10 When a property has mixed use its classification is separated between investment property and property, plant and equipment if the fair value of the investment property element can be measured reliably without undue cost or effort. If the fair value of the investment property component cannot be measured in this way, the entire property is accounted for as property, plant and equipment in accordance with Section 17. [FRS102.16.4] For example, if a property has one floor that is used as a head office but the remaining three floors are rented out, the question to consider is whether the fair value of the three remaining floors can be obtained without undue cost or effort. Under previous UK GAAP, the question to consider was subtly different, i.e. whether the three floors could have been sold separately from the remaining floor.

16.11 Continuing with the example of the shopping mall above, if the space occupied by the operator is considered to be an operating asset, then the operator should consider whether a fair value could be obtained for the remainder of the shopping mall without undue cost or effort. If so, the remainder of the shopping mall would be considered an investment property.

#### Measurement

16.12 Investment property is measured on initial recognition at its cost. Cost for a purchased investment property comprises its purchase price and any directly attributable expenditure, e.g. legal and brokerage fees, property transfer taxes, and other transaction costs. [FRS102.16.5] When payment is deferred beyond normal credit terms, the cost is calculated as the present

value of all future payments. The cost of a self-constructed investment property is calculated in accordance with Section 17 (see paragraphs 17.8 et seq). The cost may include borrowing costs in accordance with Section 25 *Borrowing costs*.

16.13 Costs incurred on an investment property under development should cease to be capitalised when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. [FRS102.17.10(b)] In our view, this would be when the investment property is in a condition such that it is available to be let to tenants.

16.14 Subsequent expenditure connected with the investment property would be expensed unless the expenditure itself meets the general asset recognition criteria i.e. it is probable that future economic benefit associated with the item will flow to the entity and the cost of the item can be measured reliably.

16.15 Investment property whose fair value can be measured reliably without undue cost or effort is measured at fair value at each reporting date, with changes in fair value recognised in profit or loss. If a property interest held under a lease is classified as investment property, the item accounted for at fair value is that interest and not the underlying property.

16.16 How changes in fair value are presented within the income statement is not specified although we would expect them to be disclosed separately. Depending on the nature of the entity's operating activities, recognition as part of operating profit may be acceptable although recognition after operating profit could not be ruled out. We expect practice to vary.

16.17 Investment properties are not depreciated.

16.18 Recognition of fair value changes in the carrying value of the investment property in profit or loss is consistent with paragraph 40(2) of Schedule 1 of the Regulations (fair value accounting rules of the Companies Act) and as such is not a true and fair override of the Companies Act in order to comply with FRS 102. Previously, compliance with the non-depreciation requirements of SSAP 19 required the true and fair override provisions of the Companies Act to be invoked.

16.19 Investment property whose fair value cannot be measured reliably without undue cost or effort is accounted for as property, plant and equipment using the cost model under Section 17, which requires the property to be depreciated. [FRS102.16.7]

16.20 Based on our experience, it should be possible in the majority of cases for a fair value to be obtained for an investment property in the UK without 'undue cost or effort'. The methodology behind the valuation of an investment property is well established in the UK and FRS 102 does not require an external valuer to be involved in the fair value calculation. Given this, and the fact that the property is held for rental or capital appreciation, it should be possible to gather sufficient information to arrive at a fair value. However, it will still be the case that the level of cost or effort that is regarded as 'undue' will be a judgement depending on the facts of each particular case. See paragraph 11.90 of this publication for guidance on the calculation of fair value.

### Transfers

16.21 If a reliable measure of fair value is no longer available without undue cost or effort for an item of investment property measured using the fair value model, the entity then accounts for that item as property, plant and equipment in accordance with Section 17 until a reliable measure of fair value becomes available. The carrying amount of the investment property on that date becomes its cost under Section 17. Disclosure is made of this change, which is a change of circumstances and not a change in accounting policy. [FRS102.16.8]

16.22 Other than as set out in paragraph 16.21 of this publication, transfers of property to, or from, investment property are permitted only when the property first meets, or ceases to meet, the definition of investment property. [FRS102.16.9]

16.23 When assets transfer from owner-occupied property (or inventory) to investment property, a valuation movement from cost to fair value will arise. In our view, this valuation movement should be reflected in profit or loss rather than other comprehensive income as the uplift has arisen from the asset's classification as an investment property: it is not a valuation surplus arising on the valuation of an item of property, plant and equipment or inventory.

16.24 When investment properties are transferred to property, plant and equipment or inventories due to a change in use then, in our view, the carrying amount of the investment property on that date becomes its cost. This is consistent with the approach when a reliable measure of fair value is no longer available.

### Transition

16.25 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 for investment property is discussed in paragraphs 35.21 to 35.22 of this publication.

## vs previous UK GAAP

### Applicable standards: SSAP 19

pUK16.1 There are differences in the definition of an investment property. Under SSAP 19:

- any rental income is negotiated on an arm's length basis although FRS 102 does not specifically cover whether rent should be on an arm's length basis;
- construction and development work is completed before a property can be classified as an investment property. FRS 102 allows investment properties under development to be in scope;
- a property leased within a group is not an investment property in either the individual entity or group accounts. Under FRS 102 these are recognised as investment properties in individual entity financial statements;
- there is no concept of not being able to measure the fair value of an investment property reliably.

pUK16.2 Under SSAP 19, investment property is carried at open market value. Changes in value, other than permanent diminutions, are charged or credited through the statement of total recognised gains and losses (STRGL) to an investment revaluation reserve within shareholders' funds. Permanent diminutions are charged through the profit and loss account. Insurance companies take investment property revaluations through the profit and loss account. Under FRS 102 changes in fair value are recognised in profit or loss.

pUK16.3 Fair value is defined in FRS 102 as 'the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.' The term 'open market value' for the valuation of investment properties is not defined in SSAP 19 but is defined in FRS 15 as having 'the same meaning as in the Appraisal and Valuation Manual published by the RICS', and is reproduced in Appendix 1 to FRS 15. Only an open market value without further qualification of any sort complies with the valuation requirements of SSAP 19. In practice, fair value and open market value seem likely to be the same for investment property.

pUK16.4 Similarly to FRS 102, freehold investment properties generally are not depreciated under SSAP 19. However, under SSAP 19 investment properties held on leases may be depreciated and are required to be depreciated if the unexpired term of the lease is 20 years or less.

pUK16.5 Neither FRS 102 nor SSAP 19 requires valuations to be carried out by qualified or independent valuers. However, when a major entity holds significant levels of investment property, SSAP 19 suggests that the properties would normally be revalued annually by persons holding a recognised professional qualification and at least every five years by an external valuer.

## vs EU-IFRS

### Applicable standards: IAS 40

IFRS16.1 IAS 40 requires an entity to choose either the fair value model or the cost model. The chosen policy applies to all of an entity's investment property. There is a limited exemption from fair value accounting, which is available only on initial recognition on a property-by-property basis when fair values cannot be established reliably on an ongoing basis. FRS 102 does not offer the cost model as an immediately available option.

IFRS16.2 IAS 40 requires an entity that has chosen the cost model to disclose the fair value of investment property, with limited exceptions that apply only if the fair value was not readily determinable on initial recognition.

IFRS16.3 There is an explicit test in IAS 40.11-12 as to whether a property can be an investment property if the lessor provides ancillary services to the occupants of a property. The test considers the significance of these services compared to the arrangement as a whole. This is not specifically covered by FRS 102.

IFRS16.4 Under IAS 40.10 properties are required to be separated into different portions between own-use and investment property, when those portions could be sold separately. Under FRS 102, the property should be split into separate components only when the investment property component can be valued reliably without undue cost or effort.

IFRS16.5 There are other areas in which IAS 40 is explicit, but in respect of which FRS 102 is silent. This could imply a difference is possible in certain circumstances. For example, IAS 40.8(b) states that land held for a currently undetermined future use is an example of an investment property whilst FRS 102 is not specific on this point.

# 17 Property, plant and equipment

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## OVERVIEW OF REQUIREMENTS

- Property, plant and equipment (PP&E) is recognised as an asset only when the flow of future economic benefits to the entity associated with the item is probable, and its cost can be measured reliably.
  - Land and buildings are separable assets and are accounted for separately, even when they are acquired together.
  - PP&E is measured at cost on initial recognition. Cost includes amounts directly attributable to bringing the asset to the location and condition necessary for it to operate in the manner intended by management. The cost is discounted to present value when payment terms are deferred. Borrowing costs may be capitalised in accordance with Section 25 *Borrowing costs*.
  - After initial recognition, PP&E is measured either at cost less any accumulated depreciation and any accumulated impairment losses, or at fair value with changes in fair value generally recognised through other comprehensive income.
  - The depreciable amount of an asset is allocated to profit or loss on a systematic basis over the asset's useful life unless another section of the FRS requires the cost to be recognised as part of the cost of an asset.
  - When indicators of impairment exist, PP&E is tested for impairment in accordance with Section 27 *Impairment of assets*.
  - PP&E is derecognised on disposal, or when no future economic benefits are expected from its use or disposal. Any gain or loss on derecognition is included in profit or loss when the item is derecognised.
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## FRS 102

### Section 17

17.1 Property, plant and equipment are tangible assets that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- (b) are expected to be used during more than one period. [FRS102.17.2]

17.2 Property, plant and equipment does not include:

- (a) biological assets related to agricultural activity or heritage assets (see Section 34 *Specialised activities*); or
- (b) mineral rights and mineral reserves, such as oil, natural gas and similar non-regenerative resources; or [FRS102.17.3]
- (c) investment property whose fair value can be measured reliably without undue cost or effort (see Section 16 *Investment property*). Investment property whose fair value cannot be measured reliably without undue cost or effort is accounted for as property, plant and equipment under this section. [FRS102.17.1]

#### Recognition

17.3 An item of property, plant and equipment (PP&E) is recognised as an asset only when the flow of future economic benefits to the entity associated with the item is probable, and its cost can be measured reliably. [FRS102.17.4]

17.4 The classification of spare parts and servicing equipment depends on how and when it will be used. Usually it will be carried as inventory and recognised in profit or loss as it is consumed. However, when the expectation is that it will be used over more than one period, or if it can be used only in connection with an item of PP&E, then it will be classified as PP&E. [FRS102.17.5]

17.5 The cost of replacing parts of PP&E that require replacement at regular intervals (e.g. the roof of a building) is added to the carrying amount of the asset when incurred, if the replacement part is expected to provide incremental future benefits to the entity. The carrying amount of the parts that are replaced is derecognised. To achieve this, the parts replaced will need to have been recognised as separate components of the item of PP&E. When major components of an item of PP&E have significantly different useful life patterns, the initial cost of the asset is allocated to its major components and each component is depreciated separately over its useful life. [FRS102.17.6]

17.6 For some assets, in order to continue to use an item of PP&E (e.g. a bus), an entity may be required to perform regular major inspections for faults. The cost of a major inspection is added to the cost of the asset as a replacement, if the recognition criteria are satisfied. The carrying amount of the previous major inspection (as distinct from physical parts) will need to have been treated as a separate component and is derecognised on recognition of the new major inspection. If the cost of the previous major inspection was not identified when the asset was originally acquired or constructed, it is possible to derive a separate component by using the estimated cost of a future similar inspection as an indication of what the cost of the previous inspection component was when the item was acquired or constructed, and recognise an accelerated depreciation cost for that component. [FRS102.17.7]

17.7 Land and buildings are separable assets and are accounted for separately, even when they are acquired together. [FRS102.17.8]

#### Measurement at recognition

17.8 PP&E is measured at cost on initial recognition. [FRS102.17.9]

17.9 The cost of an item of PP&E comprises all of the following:

- (a) its purchase price, including legal and brokerage fees, import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. These can include the costs of site preparation, initial delivery and handling, installation and assembly, and testing of functionality;
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period; and

(d) any borrowing costs capitalised in accordance with Section 25 *Borrowing costs*. [FRS102.17.10]

17.10 Costs incurred on PP&E under development should cease to be capitalised when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. [FRS102.17.10(b)]

17.11 The following expenses do not form part of the cost of PP&E, and are recognised as an expense when they are incurred:

- (a) costs of opening a new facility;
- (b) costs of introducing a new product or service (including costs of advertising and promotional activities);
- (c) costs of conducting business in a new location or with a new class of customer (including costs of staff training);
- (d) administration and other general overhead costs. [FRS102.17.11]

17.12 Only costs that are directly attributable to the item of PP&E can be capitalised. All other costs would be expensed and these would include initial operating losses, additional costs incurred in the period between the PP&E being capable of operating and being fully operational, other start-up costs and costs incurred on relocating or reorganising part or all of the entity's operations.

17.13 The income and related expenses of incidental operations during construction or development of an item of PP&E are recognised in profit or loss if those operations are not necessary to bring the item to its intended location and operating condition. [FRS102.17.12]

17.14 The cost of an item of PP&E is discounted to present value when payment terms are deferred. [FRS102.17.13]

17.15 When an asset is acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets, the cost of the acquired asset is considered to be the fair value of the consideration. However, if the exchange transaction lacks commercial substance or the fair value of neither the asset received nor the asset given up is measurable reliably, the asset's cost is measured at the carrying amount of the asset given up. [FRS102.17.14]

### Measurement after initial recognition

17.16 After initial recognition, PP&E is measured using either the cost model or the revaluation model. When using the revaluation model, an entity applies it consistently to all items of PP&E in the same class.

17.17 The day-to-day costs of servicing an item of PP&E are recognised in profit or loss in the period in which the costs are incurred. [FRS102.17.15]

#### Cost model

17.18 Under the cost model, PP&E is measured at cost less any accumulated depreciation and impairment losses. [FRS102.17.15A]

17.19 The sections above regarding replacement costs and major inspection costs cover much of the subsequent expenditure that will be incurred on PP&E. All other expenditure connected with PP&E would be expensed unless the expenditure itself meets the general recognition criteria i.e. it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably.

#### Revaluation model

17.20 Under the revaluation model, PP&E is carried at fair value (revalued amount) less any subsequent accumulated depreciation and accumulated impairment losses. Assets are revalued with sufficient frequency to ensure that the carrying amount does not differ materially from the fair value at the end of the reporting period. [FRS102.17.15B]

17.21 If the revaluation model is applied then all PP&E in a class of assets will be required to be revalued. A class of assets is defined as a grouping of assets of a similar nature, function or use in an entity's operation. [FRS102.GL]

17.22 Fair value is usually determined by a market-based appraisal. The valuation of land and buildings is normally undertaken by professional valuers. If there is no market-based evidence, e.g. for specialised assets, the entity may need to use an income or depreciated replacement cost approach to estimate fair value. [FRS102.17.15C,D] See paragraph 11.90 of this publication for guidance on fair value.

17.23 Revaluation increases are recognised in other comprehensive income (OCI), except to the extent that they reverse a revaluation decrease for that item of PP&E that was previously recognised in profit or loss, in which case they are also recognised in profit or loss. Revaluation gains are recognised in a separate revaluation reserve in equity.

17.24 Revaluation decreases are recognised in OCI to the extent they reverse a previous revaluation increase in relation to the same asset, and are otherwise recognised in profit or loss. [FRS102.17.15E,F]

17.25 FRS 102 is not specific on how the accumulated depreciation of an item of PP&E is dealt with when that item of PP&E is revalued, although the net book value of the PP&E must reflect the fair value at the date of valuation. In our view, the entity chooses an accounting policy, to be applied consistently, either to:

- restate both the gross carrying amount of the asset and the related accumulated depreciation proportionately; or
- eliminate the accumulated depreciation against the gross carrying amount of the asset. In our experience, this method is more common.

### Depreciation

17.26 When the major components of an item of PP&E have significantly different patterns of economic benefit consumption, the initial cost of the asset is allocated to each major component. Each component is depreciated separately over its useful life. Other assets are depreciated over their useful lives as single assets. Land generally has an unlimited useful life and is not depreciated: land assets that have limited useful lives e.g. quarries and sites used for landfill are depreciated. [FRS102.17.16]

17.27 The depreciation charge is recognised in profit or loss unless another section of FRS 102 requires the cost to be recognised as part of the cost of an asset. For example, the depreciation of manufacturing PP&E is included in the cost of inventories (see Section 13 *Inventories*). [FRS102.17.17]

17.28 The depreciable amount of an asset (being its cost or valuation, less its residual value) is allocated on a systematic basis over its useful life. [FRS102.17.18] The residual value and/or the useful life of an asset can be affected by factors such as a change in how an asset is used, significant unexpected wear and tear, technological advances or a change in market prices. These factors may indicate that the residual value or useful life of an asset has changed since the most recent annual reporting date. If such indicators are present, an entity reviews its previous estimates and, if current expectations differ, amends the residual value, depreciation method or useful life. Changes in the residual value, depreciation method or useful life are accounted for as a change in an accounting estimate (see Section 10 *Accounting policies, estimates and errors*). The change is made on a prospective basis given that the change in estimate relates to assessments of future residual value, depreciation method or useful life, rather than changes to the carrying value of the asset. [FRS102.17.19]

17.29 Depreciation begins when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases when the asset is derecognised. Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation, the depreciation charge can be zero while there is no production. [FRS102.17.20]

17.30 The following factors are considered when determining the useful life of an asset:

- (a) the expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output;
- (b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle;
- (c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset;
- (d) legal or similar limits on the use of the asset, such as the expiry dates of related leases. [FRS102.17.21]

17.31 A depreciation method is selected that reflects the pattern in which the asset's future economic benefits will be consumed. Possible methods include the straight-line method, the diminishing balance method, and a method based on usage, such as the units of production method. [FRS102.17.22]

17.32 Under the straight-line method, depreciation is measured such that the amount of depreciation for each year in the asset's useful life is the same.

17.33 The diminishing-balance method is measured as a percentage of the current carrying amount of the asset and as such the charge declines over the years. This would be appropriate when the item of PP&E provides greater benefits to the entity in its earlier years.

17.34 Under the units-of-production method, depreciation is based on the level of output or usage to be achieved over the asset's useful life. Estimates of future output/usage are required to be calculated and revised as necessary to enable this method to function.

17.35 The depreciation method selected is required to reflect the pattern in which the asset's future economic benefits will be consumed. Methods that do not follow this requirement are therefore not appropriate. 'Annuity depreciation' is structured to reflect the time value of money as well as consumption of economic benefits. In our view, this would not result in a method following the requirements of this standard and as such annuity depreciation is not an acceptable method.

17.36 For all depreciation methods, when there is an indication that the asset's usage pattern has changed significantly since the last reporting date, the depreciation method is reviewed. If current expectations differ, the depreciation method is changed to reflect the new pattern. The change is accounted for as a change in an accounting estimate on a prospective basis. [FRS102.17.23]

### Impairment

17.37 The requirements of Section 27 *Impairment of assets* apply at each reporting date in assessing whether an item of PP&E is impaired. Section 27 notes that a plan to dispose of an asset earlier than previously expected is an indicator of impairment, triggering the need to calculate its recoverable amount. [FRS102.17.24,26]

17.38 Any compensation for impairment from third parties for items of PP&E that were impaired, lost or given up is recognised in profit or loss only when the compensation is virtually certain to be received. [FRS102.17.25]

### Derecognition

17.39 An item of PP&E is derecognised on disposal, or when no future economic benefits are expected from its use or disposal. [FRS102.17.27] A gain or loss on derecognition is included in profit or loss when the item is derecognised, unless the transaction is a sale and leaseback to which the requirements of Section 20 *Leases* apply. Gains on derecognition are not classified as revenue. [FRS102.17.28]

17.40 The disposal date of an item is determined by applying the criteria for recognising revenue from the sale of goods in Section 23 *Revenue*, except for a sale and leaseback disposal, to which Section 20 applies. [FRS102.17.29]

17.41 The gain or loss arising from derecognition of an item of PP&E is the difference between the net disposal proceeds and the carrying amount of the item. [FRS102.17.30]

### Disclosure exemption

17.42 Qualifying entities applying FRS 102 are exempt from certain disclosure requirements of Section 17. See paragraph 3.8 of this publication.

### Transition

17.43 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 for PP&E is discussed in paragraphs 35.21 to 35.22 and 35.35 of this publication.

## vs previous UK GAAP

### Applicable standards: FRS 3, FRS 15, UITF 5, UITF 23

pUK17.1 FRS 15 indicates that non-specialised properties should be valued at existing use value, specialised properties at depreciated replacement cost, properties surplus to an entity's requirements at open market value, and other tangible fixed assets using market value when possible (and if that is not available then depreciated replacement cost). Under FRS 102 all PP&E is valued at fair value.

pUK17.2 Interest methods of depreciation such as 'annuity' depreciation, when the depreciation charge increases over the life of the asset to reflect the time value of money, are used by some operating lessors. In our view, such a methodology is not available under FRS 102.

pUK17.3 Provided certain conditions are met, 'renewals accounting' may be adopted under FRS 15. Under renewals accounting, an infrastructure system or network may be treated as a single asset with the depreciation charge estimated as being equal to the level of annual expenditure calculated as being required to maintain the operating capacity of the asset. Actual expenditure is capitalised as incurred. The use of renewals accounting is most common in utility companies. This approach is not available under FRS 102.

pUK17.4 FRS 15.89 specifically requires that tangible fixed assets other than non-depreciable land are reviewed for impairment at the end of each reporting period if no depreciation charge is made on the grounds that it would be immaterial, or if the estimated remaining useful economic life of the asset exceeds 50 years. These specific requirements are not included in FRS 102, hence only the normal indicators of impairment under Section 27 would trigger an impairment review for these assets.

pUK17.5 A review of the useful life and, if material, the residual value is required to be performed annually whilst FRS 102.17.23 requires a review to take place only when indicators of a change in useful life or residual value exist. Under FRS 15, changes in market price do not affect residual value since it is assessed at the date of acquisition: an asset measured at valuation is assessed at the latest revaluation date. The FRS 102 definition of residual value does allow changes in market value to be taken into account.

pUK17.6 Under FRS 15, revaluation decreases are recognised in profit or loss when they are caused by a clear consumption of economic benefits. Otherwise they are recognised in the statement of total recognised gains and losses (STRGL) until the asset's carrying amount equals its depreciated historical cost, and then in profit or loss. However, the loss is also recognised in the STRGL rather than in profit or loss to the extent that the recoverable amount of the asset is greater than its revalued amount i.e. value in use exceeds net realisable value. Under FRS 102 there is no specific concept of revaluation decreases being caused by a clear consumption of economic benefits.

pUK17.7 UITF 5 covers the treatment of assets transferred from current to fixed. Current asset accounting rules are applied up to the date of transfer (which is not backdated) i.e. when management's intent for the asset changed. The transfer is made at the lower of cost and net realisable value (NRV) with any differences in the carrying value taken to profit or loss. After the transfer date, fixed asset accounting rules apply. Assets transferred at NRV are accounted for as fixed assets at valuation; at subsequent balance sheet dates these assets need not be revalued but the disclosure requirements for assets held at valuation still apply. There is no equivalent guidance to UITF 5 under FRS 102. FRS 102.17.13 states that the 'cost' of PP&E is the cash price equivalent at recognition date. Accordingly, if the value of the item had increased during the period it was held as inventory, it may be possible to recognise it at a higher value under FRS 102 than under previous UK GAAP.

## vs EU-IFRS

### Applicable standards: IAS 16, IAS 23, IFRS 5, IFRIC 1

IFRS17.1 PP&E that is held for sale is excluded from the scope of IAS 16 and is accounted for in accordance with IFRS 5. Under that standard, a non-current asset or disposal group held for sale is carried at the lower of carrying amount and fair value less costs to sell and is disclosed within current assets. There is no separate guidance in FRS 102 for non-current assets held for sale.

IFRS17.2 Borrowing costs directly attributable to the construction or acquisition of PP&E are required to be capitalised as part of its cost. Under FRS 102 there is an accounting policy choice as to whether to capitalise directly attributable borrowing costs on qualifying assets, or to expense them.

IFRS17.3 A review of the residual value, useful life and depreciation methods used is performed at least at each financial year end. Under FRS 102, such a review of residual value and useful life is only required when indicators of change are present. In the case of the depreciation method, there needs to be an indication of a significant change in consumption before a review occurs.



# 18 Intangible assets other than goodwill

## OVERVIEW OF REQUIREMENTS

- An intangible asset is an identifiable non-monetary asset without physical substance.
- An intangible asset is identifiable if it is separable or arises from contractual or legal rights.
- An intangible asset acquired in a business combination is recognised separately from goodwill unless it arises from legal or contractual rights, transactions in similar assets are not seen and its fair value cannot be estimated without using immeasurable variables.
- Costs of internally generated intangible assets are split between those incurred during the research phase and those incurred in the development phase. Costs incurred during the research phase are expensed as incurred. Costs incurred in the development phase may be capitalised (an accounting policy choice) but only if certain conditions are met.
- Expenditure on internally generated brands and logos, start-up activities, training, advertising and promotion, relocation of the entity and internally generated goodwill is expensed as incurred.
- Other separately acquired intangibles are recognised in the balance sheet when it is probable that future economic benefits will flow to the entity and their cost or value can be measured reliably.
- Intangible assets are measured initially at cost, which is a valuation if they are acquired in a business combination, by way of government grant or by way of an exchange of non-monetary assets.
- Intangible assets are subsequently measured either at cost, or (if criteria are met) at fair value, less accumulated amortisation and impairment losses. Any revaluation gains or losses whilst the fair value remains above cost are recognised in other comprehensive income; gains or losses when fair value is below cost are recorded in profit or loss.
- All intangible assets are considered to have a finite useful life. The useful life is presumed to not exceed five years<sup>1</sup> unless a reliable estimate of the useful life can be made.

1. The maximum period is ten years for periods beginning on or after 1 January 2016 (or earlier adoption of the July 2015 amendments to FRS 102 – see paragraph INT.6 of this publication). The July 2015 amendments to FRS 102 also clarify that an inability to make a reliable estimate of the useful life of an intangible asset is expected to arise only in exceptional cases.



## FRS 102

### Section 18

#### Scope

18.1 Section 18 applies to the accounting for all intangible assets except:

- goodwill – see Section 19 *Business combinations and goodwill*;
- intangible assets held by an entity for sale in the ordinary course of business – see Section 13 *Inventories* and Section 23 *Revenue*;
- heritage assets – see Section 34 *Specialised activities*;
- deferred acquisition costs and other assets in the scope of FRS 103; and
- mineral rights and mineral reserves, such as oil, natural gas and similar non-regenerative resources – see Section 34. [FRS102.18.1,1A,3]

#### Definition

18.2 An intangible asset is an identifiable non-monetary asset without physical substance. Such an asset is identifiable when:

- it is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or
- it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity, or from other rights and obligations. [FRS102.18.2]

There may be instances in which an intangible asset is incorporated within a physical asset, e.g. computer software may be held on a physical disk. An entity uses judgement, based on the definitions in FRS 102, to determine whether such an asset should be classified as an intangible asset or as property, plant and equipment.

#### Recognition

18.3 An intangible asset is recognised when it is probable that the entity will receive the expected future economic benefits attributable to the asset, and its cost or value can be measured reliably. [FRS102.18.4]

18.4 Management uses judgement and reasonable assumptions to assess the degree of certainty attached to expected future economic benefits attributable to an asset. More weight is given to external evidence. [FRS102.18.5,6]

18.5 When an intangible asset is acquired separately it is always considered probable that future economic benefits will flow to the entity. [FRS102.18.7]

18.6 When acquired as part of a business combination an intangible asset's fair value (see paragraph 11.90 of this publication for guidance) can usually be measured reliably and, therefore, the asset is recognised. However, an intangible asset acquired in a business combination is not recognised when it arises from legal or other contractual rights, and there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables. [FRS102.18.8]

#### Initial measurement

18.7 Intangible assets are measured initially at cost. [FRS102.18.9]

18.8 The cost of an intangible asset is determined as follows:

- For a separately acquired intangible asset, cost comprises purchase price, including import duties and non-refundable purchase taxes but net of trade discounts and rebates, and any costs directly attributable to preparing the asset for its intended use. [FRS102.18.10]
- For an internally generated intangible asset, cost comprises the directly attributable costs incurred after a certain point in the project (see paragraph 18.16 of this publication). [FRS102.18.10-10A]
- For an intangible asset acquired in a business combination, cost is the asset's fair value at the acquisition date. [FRS102.18.11]

- For an intangible asset acquired by way of a grant, cost is the asset's fair value on the date the grant is received or receivable. [FRS102.18.12]
- For an intangible asset acquired through an exchange of non-monetary assets, cost is the asset's fair value unless the transaction lacks commercial substance or the fair value of both the asset(s) given up and the asset(s) received cannot be measured reliably. In that case, the carrying amount of the asset given up is used as the cost of the intangible asset acquired. [FRS102.18.13]

### Internally generated intangible assets

18.9 In assessing whether the recognition criteria are met for an internally generated intangible asset, its generation is split into a research phase and a development phase, defined as:

- Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

18.10 If an entity cannot distinguish between the two phases then all expenditure on the project is treated as relating to the research phase. [FRS102.18.8B]

18.11 Expenditure relating to the research phase of a project is expensed as incurred. Examples of research activities include obtaining new knowledge and searching for and evaluating alternative materials, products, processes, systems or services. [FRS102.18.8G]

18.12 Other examples of expenditure that are expensed rather than recognised as an intangible asset, include expenditure on:

- internally generated brands, logos, publishing titles and customer lists;
- start-up activities, including for example legal and secretarial costs incurred in establishing a legal entity, pre-opening costs of a new facility or business, and expenditure for starting new operations or launching new products or processes (i.e. pre-operating costs);
- training activities;
- advertising and promotional activities (but see paragraphs 13.5 and 13.21 of this publication in relation to inventories of, for example, marketing materials);
- relocating or reorganising part of an entity; and
- internally generated goodwill. [FRS102.18.8C]

18.13 On the other hand, examples of development activities include:

- the design, construction and testing of pre-production prototypes;
- the design of tools, jigs, moulds, etc. using new technology;
- pilot plants; and
- designing alternative materials, products, processes, systems or services. [FRS102.18.8J]

18.14 An entity makes an accounting policy choice to capitalise expenditure in the development phase as an intangible asset or recognise it as an expense. If it adopts a policy of capitalisation this applies to a development if, and only if, the entity can demonstrate that a series of criteria have all been met. These are:

- the project is technically feasible;
- the entity intends to complete the project and use or sell the intangible asset;
- the entity is able to sell or use the asset;
- it is probable that the asset will generate future economic benefits;

- the entity has sufficient resources to complete the project; and
- the entity can measure reliably the directly attributable expenditure. [FRS102.18.8H]

18.15 If these criteria are met then, from the date at which these criteria are met, all costs that are directly attributable to creating, producing, and preparing the asset to be capable of operating in the manner intended by management are capitalised. [FRS102.18.10A,10B]

18.16 Directly attributable costs include the costs of materials, services and employees used to generate the asset. They also include legal registration fees and the amortisation of licences and patents used in generating the intangible asset. Borrowing costs are capitalised when the entity has adopted a policy of capitalising borrowing costs for qualifying assets in line with Section 25 *Borrowing costs*. [FRS102.18.10B]

18.17 If these requirements are not met, or a policy of capitalisation of development expenditure is not adopted, the costs are expensed in profit or loss as incurred. [FRS102.18.8K]

18.18 Expenditure that has been expensed cannot be 'revived' and capitalised at a later date as part of the cost of an asset. [FRS102.18.17]

### Subsequent measurement

18.19 Intangible assets are measured after initial recognition using either:

- the cost model; or
- the revaluation model, provided that fair value can be determined by reference to an active market. The revaluation model is applied consistently to all such intangible assets of the same class. [FRS102.18.18]

18.20 An active market is one in which willing buyers and sellers normally can be found at any time for items that are homogeneous and for which prices are available to the public. By requiring the fair value to be measured with reference to an active market, FRS 102 requires a high threshold to be met for entities to be able to apply the revaluation model.

#### Cost model

18.21 Under the cost model, intangible assets are measured at cost less any accumulated amortisation and impairment losses. [FRS102.18.18A]

#### Revaluation model

18.22 Under the revaluation model, an intangible asset is carried at its fair value (revalued amount) less any subsequent accumulated amortisation and impairment losses. Fair value is determined by reference to an active market. Assets are revalued with sufficient frequency that the revalued amount does not differ materially from the fair value at the period end. [FRS102.18.18B,18D]

18.23 Revaluation gains and losses relating to an asset are recorded in profit or loss while the fair value of that asset is below cost, and other comprehensive income (OCI) otherwise. Revaluation gains or losses recognised in OCI are recorded in equity.

18.24 When an active market for an intangible asset no longer exists, its carrying value is its last revaluation less accumulated amortisation and impairment. [FRS102.18.18E]

18.25 The revaluation model is applied after the asset has been measured initially at cost and does not permit either the revaluation of intangible assets that have not been previously recognised, or the initial recognition of an intangible asset at an amount other than cost. [FRS102.18.18C]

### Amortisation and useful life

18.26 All intangible assets are considered to have a finite useful life. For intangible assets arising from contractual or legal rights, the useful life does not exceed the period of the contractual or legal rights, although it may be shorter if the period over which the entity expects to use the asset is shorter. If the contractual or legal rights can be renewed, the useful life of the intangible asset includes the renewal period only if there is evidence to support renewal by the entity without significant cost. [FRS102.18.19]

18.27 The useful life of an intangible asset is presumed to be no more than five years<sup>2</sup> unless a reliable estimate of its life can be made. [FRS102.18.20]

18.28 The depreciable amount of an intangible asset is allocated on a systematic basis over its useful life. [FRS102.18.21] Amortisation commences when the intangible asset is available for use. An asset is available for use when it is in the location and condition necessary for it to be used in the manner intended by management. Generally this will be the date of purchase but in some arrangements an asset may not be available for use until a later date. An amortisation method is chosen that reflects the pattern of expected consumption of the asset's future economic benefits. If a pattern of consumption cannot be determined reliably, the straight-line method is used. Often a straight-line method will be the most appropriate method but other methods may be more appropriate in specific circumstances. For example, a software licence allowing the user a predetermined number of downloads might be amortised on a 'per download' basis. [FRS102.18.22]

18.29 The amortisation charge is expensed, unless it is required by another section of FRS 102 to be recognised as part of the cost of an asset, e.g. inventory. [FRS102.18.21]

18.30 It is assumed that the residual value of an intangible asset is zero unless either a third party is committed to purchase the asset at the end of its useful life, or the residual value can be determined by reference to an active market and it is probable that such a market will exist at the end of the asset's useful life. [FRS102.18.23]

18.31 Indicators such as technological advancement, changes in market prices or a change in the use of an intangible asset may provide evidence that the useful life or residual value has changed in the reporting period. When such indicators exist, the estimates of residual value, useful life or amortisation method are reviewed and amended as appropriate. Changes are accounted for prospectively as a change in accounting estimate. [FRS102.18.24]

### Impairment losses

18.32 An entity applies Section 27 *Impairment of assets* to determine whether an intangible asset is impaired. [FRS102.18.25]

### Derecognition

18.33 Intangible assets are derecognised on disposal or when no future economic benefits are expected from the asset's use or disposal. Any resultant gain or loss is recognised in profit or loss. [FRS102.18.26]

### Transition

18.34 FRS 102 permits an adopter to measure an intangible asset that meets the recognition criteria as well as the criteria for revaluation described above at either fair value at the date of transition or the amount of a revaluation that took place before transition. [FRS102.35.10(c),(d)] FRS 102 does not contain any other exemptions that apply solely to intangible assets on first-time adoption of the standard. However, application of the standard to business combinations that took place before the date of transition may result in different intangible assets being recognised. [FRS102.35.10(a)]

1. The maximum period is ten years for periods beginning on or after 1 January 2016 (or earlier adoption of the July 2015 amendments to FRS 102 - see paragraph INT.6 of this publication). The July 2015 amendments to FRS 102 also clarify that an inability to make a reliable estimate of the useful life of an intangible asset is expected to arise only in exceptional cases.

**vs previous UK GAAP****Applicable standards: SSAP 13, FRS 7, FRS 10, UITF 24, UITF 27, UITF 29, UITF 34**

pUK18.1 The recognition criteria for intangible assets under FRS 10 are different from those in FRS 102:

- An item acquired in a business combination that would otherwise be an intangible asset but is not separable (i.e. it cannot be sold or transferred without disposing of a business of the entity) is accounted for as part of goodwill.
- If an intangible asset acquired as part of the acquisition of a business does not have a readily ascertainable market value (defined in a similar way to an active market), its fair value is limited to an amount that does not create or increase any negative goodwill arising on the acquisition.

pUK18.2 There is a rebuttable presumption that the useful economic lives of intangible assets are limited to a maximum of 20 years. This presumption can be rebutted only if the durability of the acquired business or intangible asset can be demonstrated and the goodwill or intangible asset is capable of continued measurement. In such cases, the useful economic life may be indefinite.

pUK18.3 Intangible assets are tested for impairment annually if they are amortised over a period longer than 20 years, or are not amortised. A separate impairment test is carried out at the end of the first full year after their acquisition.

**vs EU-IFRS****Applicable standards: IAS 20, IAS 38, SIC-32, IFRS 3**

IFRS18.1 Under IAS 38, expenditure on certain internally generated intangibles (i.e. development costs meeting specified criteria) are capitalised; there is no accounting policy choice.

IFRS18.2 Borrowing costs directly attributable to the production of a qualifying intangible asset are capitalised as part of its cost; again, there is no accounting policy choice.

IFRS18.3 When intangible assets are acquired free of charge or for nominal consideration by way of a government grant, IAS 20 permits the assets to be recognised initially either at their fair value or at the nominal consideration.

IFRS18.4 Intangible assets may be considered to have a finite or indefinite useful life under IAS 38. Intangible assets with an indefinite useful life are not amortised. Intangible assets that are not subject to amortisation (e.g. intangible assets with an indefinite life or those assets not yet in use) are tested annually for impairment. Goodwill is not amortised.

IFRS18.5 FRS 102.18.8 refers to non-recognition of an intangible asset acquired in a business combination when the fair value of an intangible asset arising from contractual or legal rights cannot be measured reliably because there is a lack of exchange transactions. Under EU-IFRS, if an intangible asset acquired as part of a business combination is separable or arises from contractual or other legal rights then sufficient information is deemed to exist to measure its fair value reliably.

# 19 Business combinations and goodwill

## OVERVIEW OF REQUIREMENTS

- A business combination is the bringing together of separate entities or businesses into one reporting entity.
- The acquisition date is the date on which the acquirer obtains control of the acquiree.
- Merger accounting may be applied for group reconstructions, and public benefit entity (PBE) combinations that are a merger, provided certain criteria are met.
- Under merger accounting the carrying values of the assets and liabilities are not adjusted to fair value.
- Business combinations (other than group reconstructions and PBE combinations that are either a merger or, in substance, a gift) are accounted for using the purchase method as described below.
- The combining entity that obtains control of the other combining entities or businesses is identified as the acquirer.
- The cost of a business combination is measured at fair value at the acquisition date and includes any directly attributable costs. Contingent consideration is included in the cost at its estimated amount and is subsequently tried-up with any adjustments taken to goodwill.
- The acquirer allocates the cost of the business combination by recognising at their fair value the acquiree's identifiable assets, liabilities and contingent liabilities, save that deferred tax, employee benefit arrangements, and share-based payments are measured in accordance with their relevant sections of FRS 102.
- The difference between the cost of the business combination and the acquirer's interest in the net fair value of the acquiree's assets, liabilities and recognised contingent liabilities is accounted for as goodwill or 'negative goodwill'.
- After acquisition, goodwill is measured at cost less accumulated amortisation and impairment losses. The presumed life of goodwill is five years<sup>1</sup> or less, unless a longer (but finite) useful life can be supported.
- Negative goodwill is recognised initially in the balance sheet and subsequently in profit or loss, primarily in the period in which the acquired non-monetary assets are recovered.
- If the initial accounting for a business combination is incomplete at the reporting date, provisional amounts are recognised for the items for which it is incomplete. If additional information becomes available about the acquisition date values of those items in the twelve months after the acquisition date, the initial accounting is adjusted retrospectively (i.e. restated) to reflect that new information.

1. The maximum period is ten years for periods beginning on or after 1 January 2016 (or earlier adoption of the July 2015 amendments to FRS 102 - see INT.6 of this publication). The July 2015 amendments to FRS 102 also clarify that an inability to make a reliable estimate of the useful life of an intangible asset is expected to arise only in exceptional cases.

## FRS 102

### Section 19

19.1 This section discusses the accounting for all business combinations except for the formation of joint ventures and public benefit entity combinations (see Chapters 15 and 34J of this publication respectively). [FRS102.19.2, FRS102.PBE19.2A]

#### Definition

19.2 A business combination is the bringing together of separate entities or businesses into one reporting entity. [FRS102.19.3] A business is defined as an integrated set of activities and assets conducted and managed for the purpose of providing a return to investors or lower costs or other economic benefits directly and proportionately to policyholders or participants. [FRS102.GL]

#### Purchase method

19.3 Business combinations are accounted for using the purchase method unless they are group reconstructions: these may be accounted for by applying the merger accounting method, provided certain conditions are met (see paragraph 19.27 of this publication). The purchase method involves:

- (a) identification of an acquirer;
- (b) measurement of the cost of the business combination; and
- (c) allocation, at the acquisition date, of the cost of the business combination to the assets acquired and liabilities and provisions for contingent liabilities assumed. [FRS102.19.7]

#### Identifying the acquirer

19.4 Under FRS 102, one party is always identified as the acquirer.

19.5 The combining entity that obtains control of the other combining entities or businesses is the acquirer. [FRS102.19.8] Control is defined as the power to govern the financial and operating policies of an entity so as to benefit from its activities. [FRS102.GL] Indicators that an entity is the acquirer include:

- the entity's fair value is significantly greater than the other;
- the entity gives up cash or other assets as consideration for voting ordinary equity instruments of the other; and
- the entity's management team dominated the selection of the management team of the combined entity. [FRS102.19.10]

19.6 It follows that the acquirer identified for accounting purposes may not always be the same as the entity that acquires the other's shares. This is sometimes termed a 'reverse acquisition' and would require a true and fair override of the position under the Companies Act to account for the legal acquiree as the acquirer and the legal acquirer as the acquiree.

#### Acquisition date

19.7 The acquisition date is the date the acquirer obtains control of the acquiree. [FRS102.19.17] It may not be necessary for a transaction to be finalised at law for the acquirer to obtain control.

#### Cost of a business combination

19.8 The acquirer measures the cost of a business combination as the aggregate of:

- (a) the fair values, at the acquisition date, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; and
- (b) any costs directly attributable to the business combination. [FRS102.19.11]

19.9 If the cost of a business combination includes an element of consideration contingent on future events, the acquirer estimates and includes that element of consideration in the cost of the business combination if it is considered probable that it will be paid and it can be measured reliably. [FRS102.19.12] If payment of an additional amount of contingent consideration subsequently becomes probable or measurable reliably, it is treated as an adjustment to the cost of the combination. [FRS102.19.13] There is no time limit for this adjustment.

19.10 FRS 102 does not specifically address other movements in the amount recorded as a contingent consideration liability. For example, it does not consider movements that arise because payment of contingent consideration is no longer considered



probable. Recognising such changes as an adjustment to goodwill would be consistent with both IFRS 3 (2004) and FRS 7 and the treatment in FRS 102.19.13.

#### Allocating the cost of a business combination to the assets acquired and liabilities and contingent liabilities assumed

19.11 The acquirer records the assets and liabilities and contingent liabilities that it has acquired as follows. For an acquiree's intangible asset or contingent liability to be recognised, it is necessary only that its fair value can be measured reliably. [FRS102.18.8,19.15(c)] For any other asset/liability (other than deferred tax, employee benefits and share-based payments, for which see paragraphs 19.14 to 19.15 of this publication), in addition to the need for reliable measurement at fair value, it must also be probable that future benefits/resources will flow to/from the entity. [FRS102.19.15]

19.12 Only assets, liabilities, and contingent liabilities that existed at the acquisition date and satisfy the recognition criteria (described in the preceding paragraph) are recognised. As such, restructuring or downsizing costs are recognised as part of the acquisition only when the acquiree had an existing liability for restructuring in accordance with Section 21 *Provisions and contingencies* at the acquisition date. Future losses or other costs expected to be incurred as a result of the business combination are not recognised as liabilities by the acquirer on acquisition. [FRS102.19.18]

19.13 At the acquisition date, the acquiree's identifiable assets and liabilities and contingent liabilities that satisfy the recognition criteria are brought in at their fair values at that date. The differences between the cost of the business combination and the acquirer's interest in the net fair value (i.e. net of any non-controlling interest's share, see paragraph 9.32 of this publication) of the identifiable assets, liabilities and recognised contingent liabilities is accounted for as goodwill or so-called 'negative goodwill'. [FRS102.19.14] Special rules exist for the calculation of goodwill in a step acquisition (see paragraph 19.26 of this publication).

19.14 At the acquisition date, the acquirer recognises and measures deferred tax assets and liabilities arising from the assets acquired and liabilities assumed in accordance with Section 29 *Income tax*. Deferred tax is recognised in respect of any additional tax consequences of any differences between the amount that will be deducted or assessed for tax, and the fair value of acquired assets and liabilities. No deferred tax is recognised, however, on the initial recognition of goodwill. [FRS102.19.15A, FRS102.29.11]. Refer also to paragraph 29.17 of this publication.

19.15 If the acquiree has any employee benefit arrangements, the acquirer recognises and measures any assets or liabilities related to those arrangements at the acquisition date in accordance with Section 28 *Employee benefits*. [FRS102.19.15B] Similarly, share-based payments are recognised and measured in accordance with Section 26 *Share-based payment*. [FRS102.19.15C]

19.16 Post-acquisition, the results of the acquiree are included in the acquirer's statement of comprehensive income based on the fair values recognised at the acquisition date. For example, depreciation of property, plant and equipment is calculated based on its acquisition date fair value, which is treated as its cost to the acquirer. [FRS102.19.16]

19.17 Post-acquisition, the acquirer measures contingent liabilities at the higher of:

- the amount that would be recognised in accordance with Section 21; and
- the amount recognised initially less amounts previously recognised as revenue in accordance with Section 23 *Revenue*. [FRS102.19.21]

19.18 If the initial accounting for the business combination is incomplete at the end of the period in which the business combination took place, the acquirer recognises provisional amounts for the items for which the accounting is incomplete. It then has until twelve months from the acquisition date to make adjustments to those amounts to reflect new information obtained about the acquisition date fair value of those assets and liabilities. Such adjustments are made as at the original acquisition date, i.e. by restating the prior year if the acquisition took place in the prior year.

19.19 Beyond twelve months, adjustments to the initial accounting for a business combination are recognised only to correct an error in accordance with Section 10 *Accounting policies, estimates and errors*, and in respect of the remeasurement of contingent consideration. [FRS102.19.19]

19.20 Whilst FRS 102.19.19 discusses hindsight period adjustment to 'assets and liabilities' acquired, it does not specifically refer to contingent liabilities recorded as part of the business combination. Since contingent liabilities are required to be recorded as a provision at the acquisition date (i.e. they are treated as a liability at that date), they would also be subject to the same hindsight period rules.



## Goodwill

19.21 At the acquisition date, the acquirer recognises goodwill acquired in a business combination as an asset. It is measured as the excess of cost over the acquirer's interest in the net fair value of the assets, liabilities and contingent liabilities recognised on acquisition (subject to specific rules for goodwill arising on a step acquisition - see paragraph 19.26 of this publication). [FRS102.19.22]

19.22 After initial recognition, goodwill is measured at cost less accumulated amortisation and accumulated impairment losses. Goodwill is amortised on a systematic basis over its useful life, which is considered to be finite. Goodwill has no residual value. [FRS102.18.23] If a reliable estimate of the useful life of goodwill cannot be made then it is presumed to be five years<sup>1</sup>. The amortisation period and method are reviewed when events and circumstances indicate that the useful life may have changed since the last reporting date. Goodwill is tested for impairment in accordance with Section 27 *Impairment of assets*. [FRS102.19.23]

19.23 When the acquirer's interest in the net fair value of the identifiable assets, liabilities and provisions for contingent liabilities acquired exceeds the cost of the business combination (sometimes referred to as 'negative goodwill'), the acquirer:

- (a) reassesses the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination;
- (b) records any excess that remains after reassessment on the balance sheet immediately below any positive goodwill (striking a net total of the positive and negative goodwill); and
- (c) recognises the excess in profit or loss in the periods in which the non-monetary assets acquired are recovered. Any excess over the fair value of non-monetary assets acquired is recognised in profit or loss in the periods expected to benefit. [FRS102.19.24]

## Non-controlling interests

19.24 A non-controlling interest (NCI) is defined as the equity in the subsidiary not attributable directly or indirectly to the parent. NCI is recognised at the date of the acquisition as the NCI holders' net interest in the fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree recognised at the acquisition date. See paragraphs 9.28 to 9.33 of this publication.

### Example 19.1

On 31 October 20X1 company P acquires 60% of company S for cash of £1,000. The fair value of the identifiable net assets of S is £1,500.

In its consolidated financial statements, P recognises the identifiable net assets of S at their fair value of £1,500, NCI of £600 (£1,500 x 40%), and goodwill of £100 (£1,000 - (£1,500 x 60%)).

19.25 Note that the amount recorded as NCI as a result of this calculation does not include any share of goodwill. Similarly, the goodwill reflects only the parent's interest in the goodwill. [FRS102.19.22(b)]

## Step acquisitions

19.26 An acquirer may gain control of an investee in which it previously held an interest (a step acquisition). The legal appendix to FRS 102 determines the accounting for such transactions. When the existing interest is no longer held at its original cost (e.g. because it has been impaired, remeasured to fair value or subject to equity accounting), the goodwill is calculated based on the difference between the cost and share of net assets acquired at each step of the transaction. Using this method, 100 percent of the identifiable net assets are nevertheless recognised at fair value on acquisition and a revaluation reserve arises on the revaluation of the share of net assets previously held. [FRS102.A4.18-21]

1. The maximum period is ten years for periods beginning on or after 1 January 2016 (or earlier adoption of the July amendments to FRS 102 – see paragraph INT.6 of this publication). The July 2015 amendments to FRS 102 also clarify that an inability to make a reliable estimate of the useful life of goodwill is expected to arise only in exceptional cases.

**Example 19.2**

Company X acquires the remaining 75% of its associate, Company Z, which then becomes its subsidiary. At this point X had in its financial statements an equity-accounted investment of £210, as follows:

	Original cost £	Subsequent profit £	Total £
Goodwill	25	-	25
Share of net assets	175	10	185
<b>Total</b>	<b>200</b>	<b>10</b>	<b>210</b>

X paid £750 for the remaining 75%. The fair value of the net assets at that point was £840. Goodwill is calculated as:

	£	£
Already present in equity accounting	-	25
Price paid for 75% stake	750	-
75% of the fair value of net assets at that date (75% x £840)	(630)	
		<b>120</b>
<b>Goodwill</b>		<b>145</b>

Note that as part of the acquisition accounting the net assets underlying the equity accounting will be revalued from £185 (based on fair values at the date of becoming an associate plus subsequent share of profits) to £210 (£840 x 25%, based on fair values at the date of obtaining control), i.e. revalued by £25.

The double entry is:

	Dr £	Cr £
Goodwill	145	-
Net assets	840	
Cash paid		750
Investment in associate		210
Revaluation reserve		25

The legal appendix to FRS 102 explains that this accounting is an instance of the true and fair override of the method provided in the Companies Act and FRS 102.19.11A. That method would have calculated goodwill as £110, being: the sum of the original cost of each tranche, £200 + £750 = £950; less the fair value of the net assets on acquiring control; i.e. £950 - £840 = £110. A goodwill figure of £110 is net of the revaluation credit of £25 and a reversal of the prior equity accounting profit of £10 (i.e. £145 - £25 - £10 = £110). The legal appendix explains that this method is required whenever the Companies Act's/FRS 102.19.11A's method would be inconsistent with the way that the investment has previously been treated (which is likely to be the case whenever the investment is no longer recorded at the amount that it originally cost).

**Merger accounting**

19.27 Merger accounting may be used for a group reconstruction provided:

- merger accounting is not prohibited by applicable legislation<sup>2</sup>;
- the ultimate equity holders and their relative rights remain the same; and
- any non-controlling interest in the net assets of the group remains unchanged. [FRS102.19.27]

19.28 A group reconstruction is any one of the following arrangements:

2. SI 2015/980 amends the Regulations with effect from 1 January 2016. The amendments include a change in the conditions for accounting for an acquisition as a merger.

- the transfer of an equity holding in a subsidiary from one group entity to another;
- the addition of a new parent entity to a group;
- the transfer of equity in one or more subsidiaries of a group to a new entity that is not a group entity but whose equity holders are the same as those of the group's parent; or
- the combination into a group of two or more entities that, before the combination, had the same equity holders. [FRS102. GL]

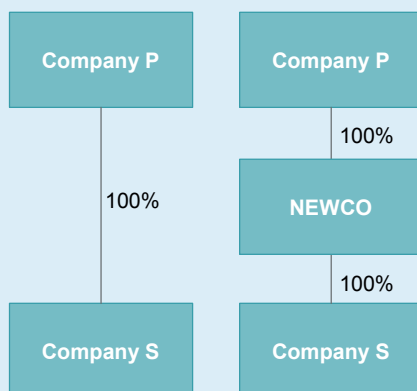
19.29 Under merger accounting:

- no fair value adjustments are made;
- adjustments are required to align accounting policies; [FRS102.19.29]
- the results and cash flows of the combining entities are presented for the combined entity for the entire period in which the combination occurred. Comparatives are restated by including the results for all of the combining entities and their balance sheets at the previous balance sheet date; [FRS102.19.30]
- the difference between the nominal value of the shares issued (plus the fair value of other consideration) and the nominal value of the shares received is shown in the statement of changes in equity as a movement in other reserves;
- existing share premium or capital redemption reserve balances of the new subsidiary are subsumed in other reserves through the statement of changes in equity in the balance sheet of the combined entity; [FRS102.19.31]
- merger expenses are charged to profit or loss in the combined entity. [FRS102.19.32]

19.30 FRS 102 also observes that when a group reconstruction is effected using a newly formed parent company, the accounting treatment depends on the substance of the business combination being effected. Presumably this implies that if acquisition accounting was under consideration, then the newly formed parent would not take the role of acquirer. [FRS102. ACA.64]

### Example 19.3

#### Transaction involving a newco



A newco acquires P's shares in S in return for issuing equity to P. In its consolidated accounts Newco does not account for the acquisition of S using the purchase method. Instead, it uses merger accounting, having met the criteria as described above. The same would apply if P was a group of individual shareholders instead of a company.

#### Transition

19.31 Exemption from retrospective application on first-time adoption of FRS 102 of certain requirements of this section of the standard is available, as discussed in paragraphs 35.10(d), and 35.12 to 35.19 of this publication.

19.32 On transition from IFRS to FRS 102, contingent consideration is remeasured from fair value to the amount expected to be paid in accordance with FRS 102.19.12, with any adjustment taken to reserves. [FRS102.35.8] Any subsequent changes to the contingent consideration would result in an adjustment to goodwill. [FRS102.19.13]

## vs previous UK GAAP

Applicable standards: FRS 6, FRS 7, FRS 10, UITF 15, UITF 22, UITF 27, UITF 42

pUK19.1 The general principles for establishing the cost of acquisition and the fair value of the assets and liabilities applying the purchase method of accounting for a business combination are similar to FRS 102, although there are a number of differences in the detail. These include the following:

- FRS 7 includes guidance on the determination of the fair values of specific items in a business combination. FRS 102 contains little guidance in this area but does include general guidance on fair value in Section 11 *Basic financial instruments*.
- Deferred tax is generally not recognised on fair value adjustments in a business combination due to the different approach to deferred tax accounting under previous UK GAAP.
- There are detailed differences in the criteria for recognising intangible assets separately from goodwill on acquisition. For example, FRS 10.2 states that to be identifiable an intangible asset must be separable; and that if the benefits embodied in an intangible asset are not controlled through legal rights or custody, then there is insufficient control to recognise an intangible asset.
- If an intangible asset recognised separately from goodwill does not have a readily ascertainable market value, its fair value is limited to an amount that does not create or increase any negative goodwill arising on the acquisition.
- Adjustments to provisional fair values and corresponding adjustments to goodwill are made prospectively (i.e. there is no prior year adjustment).
- Adjustments to provisional fair values may be made at any time in the financial statements in the financial period following that in which the acquisition was completed.

pUK19.2 There is a rebuttable presumption in FRS 10 that the useful economic life of goodwill is finite and is no more than 20 years. This presumption can be rebutted only if the durability of the acquired business or intangible asset can be demonstrated and the goodwill is capable of continued measurement.

pUK19.3 Goodwill is tested for impairment annually if it is either amortised over a period longer than 20 years, or is not amortised due to having been attributed an indefinite life.

## vs EU-IFRS

Applicable standards: IFRS 3, IFRIC 9

IFRS19.1 There are a number of differences between the requirements of FRS 102 and IFRS. For some of these, the difference may be in the detail. The most significant differences are set out below.

IFRS19.2 Transaction costs, other than share and debt issue costs, are expensed as incurred.

IFRS19.3 Contingent consideration is measured initially at fair value. The probability of all potential outcomes is taken into account in determining the fair value of the liability, but probability is not itself a recognition threshold. Contingent consideration is classified as a liability or as equity in accordance with IAS 32. Liability-classified contingent consideration is measured at fair value with adjustments in profit or loss. Contingent consideration that is classified as equity is not remeasured and any difference on settlement is accounted for in equity.

IFRS19.4 IFRS 3 has specific rules whereby the consideration is adjusted when the combination effectively settles a pre-existing relationship (e.g. a lease) between the acquirer and the acquiree. For example, with a pre-existing lease the consideration is increased/reduced by the amount that would be received/paid by the acquirer to settle the outstanding lease contract at fair value.

IFRS19.5 IFRS 3 includes detailed and sometimes prescriptive guidance on how to determine whether part of a payment relates to future services and therefore should be recorded in post-acquisition profit or loss rather than as part of the consideration for the business combination.

IFRS19.6 The fair values of previously held interests are added to consideration in determining goodwill. Any difference between the fair and book values of previously held interests are recorded in profit or loss at the acquisition date.

IFRS19.7 Similarly to FRS 102, there are a number of exceptions in IFRS 3 to the requirement to measure acquired assets and liabilities at fair value. However, IFRS 3 includes detailed rules setting out the treatment of many of these assets and liabilities, which are not replicated in FRS 102. For example, there are specific rules about the treatment of share-based payment awards in IFRS 3 that are not repeated in FRS 102. In addition, IFRS 3 exempts some contingent liabilities, indemnification assets and reacquired rights from the requirement to be measured at fair value on acquisition.

IFRS19.8 There is a transaction-by-transaction option to measure any non-controlling interest initially either at its proportionate share of the net assets acquired, as in FRS 102, or at its fair value with a consequential increase in goodwill (in fact, producing a goodwill figure as if 100 percent of the acquiree had been acquired).

IFRS19.9 Goodwill is not amortised but is tested for impairment (at least) annually.

IFRS19.10 Any bargain purchase gain (i.e. negative goodwill) is recognised in profit or loss at acquisition.

IFRS19.11 The definition of group reconstructions under FRS 102 is different from the definition of business combinations under common control in IFRS 3. For example, a transaction in which the controlling party remained the same, but for which there was a significant change in the non-controlling interest, would be a common control combination but would not qualify as a group reconstruction.

IFRS19.12 Common control combinations are scoped out of IFRS 3 and entities are often able to make an accounting policy choice between book value and IFRS 3 acquisition accounting. Whilst this choice is similar to that available for group reconstructions in FRS 102, the lack of guidance on how common control combinations are dealt with in IFRS may result in a wider choice of accounting outcomes being available. A more detailed discussion of the accounting for common control combinations under IFRS can be found in KPMG IFRG Limited's publication, *Insights into IFRS*.

# 20 Leases

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## OVERVIEW OF REQUIREMENTS

- A lease is defined as an agreement whereby the lessor gives to the lessee the right to use an asset for an agreed period of time in return for a payment or series of payments.
  - A finance lease transfers substantially all the risks and rewards of ownership to the lessee. An operating lease does not transfer substantially all the risks and rewards of ownership.
  - Classification as a finance or operating lease depends on the substance of the transaction rather than the legal form of the lease and is determined at the start of the lease term.
  - In the financial statements of lessees:
    - For finance leases, a right of use asset and finance lease liability are recognised at the fair value of the leased asset or, if lower, the present value of the minimum lease payments. The right of use asset is depreciated. A finance charge arises on the liability.
    - For operating leases, lease payments are recognised on a straight-line basis over the life of the lease unless another systematic basis is more appropriate, or lease payments are structured to increase with expected general inflation.
  - In the financial statements of lessors:
    - For finance leases, a finance lease asset equal to the net investment in the lease is recognised. Lease payments received reflect both repayment of principal and finance income.
    - For operating leases, assets are presented and depreciated as property, plant and equipment. Lease payments received are generally recognised on a straight-line basis over the life of the lease unless another systematic basis is more appropriate, or lease payments are structured to increase with expected general inflation. Property leased out under an operating lease is likely to be accounted for as investment property (see Section 16 *Investment property*).
    - When a manufacturer or dealer enters into a finance lease with its customers, this gives rise to immediate recognition of a sale and associated manufacturing profit together with finance lease income over the lease term. If a manufacturer or dealer enters into an operating lease with its customer, no sale is recognised but rental income is recognised over the lease term.
  - Sale and leaseback transactions are considered together as they are typically interlinked. Specific accounting rules apply to these transactions.
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## FRS 102

### Section 20

20.1 The following are excluded from the scope of this section:

- (a) leases to explore for or use non-regenerative resources – see Section 34 *Specialised activities*;
- (b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights – see Section 18 *Intangible assets other than goodwill*;
- (c) measurement of investment property held by lessees or provided by lessors under operating leases – see Section 16 *Investment property*;
- (d) biological assets held by lessees under finance leases or provided by lessors under operating leases – see Section 34; and
- (e) leases that could lead to a loss to the lessor or the lessee as a result of non-typical contractual terms – see paragraphs 12.4(f) and 20.6 of this publication. [FRS102.20.1]

20.2 Agreements between two contracting parties that transfer right of use assets from one party to another are within the scope of the section on leases, regardless of the level of operation and maintenance services to be supplied by the lessor. Some outsourcing and other arrangements (e.g. telecommunication contracts providing rights to capacity) do not take the legal form of a lease but convey rights to use assets in return for payments. [FRS102.20.3]

20.3 The assessment of whether an arrangement is or contains a lease depends on whether:

- fulfilment of the arrangement is dependent on the use of a specific asset(s); and
- the arrangement conveys a right to use the asset, i.e. the right to control the use of the underlying asset. [FRS102.20.3A]

20.4 The asset under the arrangement may be identified explicitly in the arrangement or it may be specified implicitly. For example, a supplier owns or leases only one asset with which to fulfil the arrangement and it is not economically feasible or practical for the supplier to use any alternative assets. [FRS102.20.3A] Example 2 of the FRC's Staff Education Note 6 *Leases* considers how to apply this guidance to a purpose-built electricity substation and an outsourcing arrangement.

20.5 When it is concluded that rights to a specific asset exist in an arrangement, then the contract should be broken down into its lease and service components and each component should be accounted for separately. This approach is consistent with FRS 102.20.15 and 20.25, which exclude amounts relating to services such as insurance and maintenance in the recognition of lease expenses and income. In our view, this separation should be completed on a relative fair value basis.

20.6 The scope exclusion in paragraph 20.1(e) of this publication is for arrangements that could lead to a loss to the lessor or the lessee as a result of contractual terms that are unrelated to normal lease terms. Normal lease terms include changes in the price of the leased asset, changes in foreign exchange rates and default of one of the counterparties. 'Changes in the price of the leased asset' can be framed widely and as such this exclusion is expected to apply only to a small percentage of lease arrangements with terms that could result in losses unrelated to the leased asset. Such arrangements are accounted for as financial instruments under Section 12 *Other financial instruments issues*, see paragraph 12.5(d) of this publication. [FRS102.ACA.65-66]

#### Classification of leases

20.7 A finance lease transfers substantially all the risks and rewards of ownership to the lessee, whereas an operating lease does not. [FRS102.20.4]

20.8 Classification as a finance or operating lease depends on the substance of the transaction rather than the legal form of the lease. A lease would normally be classified as a finance lease in any of the following circumstances:

- ownership of the asset passes to the lessee by the end of the lease term;
- the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than its fair value, such that it is reasonably certain at the beginning of the lease that the option will be exercised;
- the lease is for the major part of the asset's economic life;
- at the inception of the lease the present value of the minimum lease payments (see paragraph 20.10 of this publication) equates to substantially all of the fair value of the leased asset; or
- the leased assets are specialised in nature such that they could not be used by another lessee without major modification. [FRS102.20.5]



20.9 The lease term includes the non-cancellable period of the contract and any further periods for which the lessee has an option to continue to lease the asset. The further periods under option are included in the lease term only if, at inception of the lease, it is judged reasonably certain that the lessee will exercise that option. For example, if the lease term is six years but the lessee can cancel the lease without penalty at the end of the third year, then the non-cancellable period of the contract would be three years. However, if at the inception of the lease it is judged reasonably certain that the lessee will not cancel the lease at the end of three years, the lease term would be six years. [FRS102.GL] Specific guidance is not provided on how 'reasonably certain' should be assessed. The assessment should be based on facts and circumstances at the inception of the lease and, in our view, would need to demonstrate economic compulsion to renew rather than it being more likely than not that the lease would be renewed.

20.10 Minimum lease payments are those payments that the lessee is, or can be, required to make to the lessor over the lease term, excluding contingent rent. From the lessee's point of view, minimum lease payments also include any amount guaranteed by the lessee or a party related to the lessee (e.g. a residual value guarantee). From the lessor's point of view, minimum lease payments also include residual value guarantees by any third party unrelated to the lessor, provided that the party is financially capable of fulfilling the obligations under the guarantee. [FRS102.GL] Lease payments structured to increase in line with expected inflation would still be included in minimum lease payments as the lessee is committed to make these payments, even though they are expensed as incurred if the lease is classified as an operating lease.

20.11 Contingent rent is the portion of lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time; examples include amounts dependent on future use, future prices indices and future market rates of interest. [FRS102.GL] As it is not fixed in amount, contingent rent is not included in the calculation of minimum lease payments. For leases that are classified as operating or finance leases, contingent rent is recognised as an expense in the period it occurs. [FRS102.20.11]

20.12 In addition, minimum lease payments do not include costs for services or other costs (e.g. insurance) to be paid by the lessee to the lessor. If these items are included in a single payment being made under the lease then they need to be separated out for the calculation of minimum lease payments and accounted for as service expenses.

20.13 Other indicators of a finance lease include the lessee being obliged to bear the lessor's losses on cancellation of the lease, the lessee bearing the residual value risk of the asset, or the lessee having the option of a secondary rental period at a substantially below market rent. [FRS102.20.6] Scenarios when the lessee bears the residual risk would include when the lessor has an option to sell the asset to the lessee at a fixed price (rather than market price) at the end of the primary lease period.

20.14 The standard does not provide specific guidance on what 'substantially all of the fair value of the leased asset' is. Previous UK GAAP applied a bright line test of a 90 percent threshold. In our view, although the 90 percent threshold may provide a useful reference point, it does not represent a bright line or automatic cut-off point, otherwise it would have been included in the standard. Instead, all of the relevant factors should be considered together before arriving at a classification conclusion.

20.15 Similarly, the standard does not provide specific guidance on what constitutes the 'major part of the economic life' which is consistent with previous UK GAAP and IFRS. In some cases a measure of 75 percent, which derives from US GAAP, is used as a guide. However, this should be taken as no more than a guide in this instance.

20.16 The indicators in paragraphs 20.7 and 20.8 of this publication are not always conclusive as to the correct classification of a lease. All features of the lease are considered when determining whether the lease transfers substantially all the risks and rewards incidental to ownership. [FRS102.20.7]

20.17 Classification is determined at the inception of the lease and is not changed unless both parties agree to change the terms of the lease agreement: the lease classification is then reassessed. [FRS102.20.8] The inception of the lease is defined as the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. The commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (i.e. the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate). [FRS102.GL]

20.18 A decision by the lessee that it was likely to exercise an option to extend the lease term, under the original lease agreement, would not immediately trigger a reassessment of the lease classification as there is no jointly agreed change in the original terms of the lease.



20.19 Land is treated as a separate component when considering property, plant and equipment and, as a result, a lease containing land and buildings may need to be separated out between a land lease and a buildings lease. Classification of these leases will be considered separately and, as a consequence, the lease payments under the lease arrangement may need to be split between land and buildings. In practice, though, if the lease of the building is clearly an operating lease, based on the tests in paragraph 20.8 above, then separating the land and building components will become an unnecessary exercise. It will generally only be in cases when the building may be a finance lease that separation will be necessary.

20.20 The lease classification of land will typically assume it to have an indefinite economic life, although this does not always result in an operating lease classification. Factors to take into account would include the lease term, the present value of minimum lease payments and the nature of the lease payments. In our view, leases of land with terms over 50 years could be finance leases. Lease payments that are contingent in nature or are subject to market rate rent review would indicate that the lessor retains certain risks and rewards of the land.

### Financial statements of lessees – finance leases

20.21 At the start of the lease, the lessee recognises a right of use asset and finance lease liability in the balance sheet at the fair value of the leased asset or, if lower, the present value of the minimum lease payments determined at the inception of the lease. Any initial direct costs associated with negotiating and arranging the lease are added to the carrying amount of the asset. [FRS102.20.9]

20.22 The interest rate implicit in the lease is used to calculate the present value of the minimum lease payments (see paragraph 20.10 of this publication) unless this cannot be established. In such cases the incremental borrowing rate (see paragraph 20.23 of this publication) of the lessee is used. [FRS102.20.10] The interest rate implicit in the lease is the discount rate that, at the inception of the lease, determines the aggregate present value of:

- (a) the minimum lease payments; and
- (b) the unguaranteed residual value to be equal to the sum of:
  - i. the fair value of the leased asset; and
  - ii. any initial direct costs of the lessor. [FRS102.GL]

20.23 The incremental borrowing rate is the interest rate payable by the lessee on a comparable lease or, if that cannot be established, the interest rate the lessee would pay on a loan taken out at the start of the lease, with similar security and for a comparable term. [FRS102.GL]

20.24 After initial recognition, minimum lease payments are apportioned between a finance charge and a reduction in the finance lease liability using the effective interest method (refer to Section 11 *Basic financial instruments* and paragraph 11.68 of this publication for further guidance on the effective interest method). The finance charge is allocated such that a constant rate of interest is charged over the lease term on the remaining balance of the liability. As is the case with all leases, contingent rents are expensed as incurred. [FRS102.20.11] Contingent rents are the portion of the lease payments that are not fixed in amount but are based on the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, and future market rates of interest). [FRS102.GL]

20.25 The right of use asset is depreciated in accordance with Section 17 *Property, plant and equipment*. The asset is depreciated over the shorter of the lease term and the asset's useful life unless there is reasonable certainty that ownership will pass to the lessee at the end of the lease term. At each reporting date the asset is assessed for impairment in accordance with Section 27 *Impairment of assets*. [FRS102.20.12]

### Financial statements of lessees – operating leases

20.26 Operating lease payments (excluding costs for services such as insurance and maintenance) are recognised on a straight-line basis over the lease term. This is the case unless another systematic basis of allocating lease payments is more representative of the asset's usage pattern, or lease payments are structured to increase in line with expected general inflation (i.e. predetermined but based on consensus forecasts or published indices or statistics) to compensate the lessor for expected inflationary costs. Lease payments that are structured to increase in line with actual rates of inflation or are variable in nature, including rentals that vary according to turnover (i.e. contingent rents), are recognised as incurred. [FRS102.20.15] In our experience, when the same asset is available during the lease term then the acceptable systematic basis to recognising the expense is a straight-line basis.

20.27 The definition of 'commencement date' refers to the date from which the lessee becomes entitled to exercise its right to use the leased asset and therefore receive the benefit of its use. This means that the rent expense is recognised from that date even if the lessee is not actually using the asset. As the lessee has the right to use the asset then the lessee has the usage of the asset: whether the lessee is deriving the full expected economic benefit of the asset does not affect that conclusion.

20.28 FRS 102 has introduced a new concept whereby pre-defined increases in lease payments in line with expected inflation will be recognised on an as-incurred basis. This requires consideration at the inception of the lease as to whether any fixed rent increases set out in the lease agreement are actually structured to reflect expected general inflation rates at that point in time.

20.29 In the UK there are currently two measures of expected general inflation, the retail price index (RPI) and the consumer price index (CPI). Five-year forecasts are available from a variety of sources for these measures, as are long-term target rates. The forecasts show variances year-on-year and a variance in expectations between the parties that provide the forecasts. It appears, therefore, that expected general inflation sits within a range rather than one specific amount at a particular point in time. In our view, the assessment is whether the percentage increase applied in the lease is within the range expected by the market at the inception of the lease.

20.30 When the structured increases could not be demonstrated to be within those ranges, either if they were too low or too high, then it would be concluded that these do not reflect increases in expected general inflation: all of these structured increases would then be required to be spread over the lease term on a straight-line basis.

20.31 When there is an agreed percentage floor increase for the lease payment, along with additional payments when actual inflation increases above that floor, this would appear to provide the lessor with a fixed increase in lease payments, as well as allowing the lessor to share in the benefit when inflation runs at an above-the-floor amount. It does more than just compensate the lessor for expected inflationary costs and so it would not meet the criteria for this exemption to apply. In this case the fixed floor increases would be spread on a straight-line basis rather than recognised as incurred. Other clauses that would result in the actual annual rents changing by amounts above the original expected inflation amounts would also not meet the criteria.

20.32 When the rent varies with inflation subject to a maximum ceiling, this would meet the definition of contingent rent (given there is no minimum increase) and so would be treated as such.

20.33 A lessee recognises the aggregate benefit of lease incentives received as a reduction to the lease expense recognised over the lease term (see paragraph 20.9 above) on a straight-line basis, unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset.

20.34 Lease incentives are those provided by the lessor to the lessee to enter into, or renew, an operating lease. Examples of such incentives include up-front cash payments to the lessee, the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with pre-existing lease commitments of the lessee), or initial periods of the lease provided by the lessor rent-free or at a reduced rent. [FRS102.20.15A, FRS102.GL]

20.35 Costs incurred by the lessee (e.g. termination costs of pre-existing leases, relocation costs or leasehold improvements) are accounted for separately from the incentive and in accordance with the relevant section of FRS 102. [FRS102.20.15A]

20.36 Section 21 *Provisions and contingencies* is applicable when operating leases become onerous. [FRS102.20.15B]

### Financial statements of lessors – finance leases

20.37 The lessor recognises in its balance sheet a finance lease asset equal to its net investment in the lease. This is defined as the lessor's gross investment in the lease discounted at the interest rate implicit in the lease. The gross investment in the lease is the minimum lease payments receivable (see paragraph 20.10 above) plus any unguaranteed residual value accruing to the lessor. [FRS102.20.17]

20.38 Initial direct costs of negotiating the lease are included in the measurement of the finance lease receivable and reduce income over the lease term. This approach is not applicable for manufacturer or dealer lessors (see paragraph 20.46 below). [FRS102.20.18]

20.39 After initial recognition, finance income is recognised on a basis that reflects a constant periodic rate of return on the net investment in the finance lease. Lease payments reduce the gross investment to reflect both repayment of principal and finance income. If the residual value used in the gross investment calculation changes significantly, the income allocation is revised and any gain or loss is recognised immediately in profit or loss. [FRS102.20.19]

### Financial statements of lessors – operating leases

20.40 Assets leased under an operating lease are presented in the lessor's balance sheet in accordance with the requirements of FRS 102 applicable to the relevant type of asset, e.g. investment property (see Chapter 16 of this publication) or property, plant and equipment (see Chapter 17 of this publication). [FRS102.20.24]

20.41 Lease income (net of any incentives granted) is recognised on a straight-line basis over the lease term unless another systematic basis of allocating lease payments is more representative of the asset's consumption, or lease payments are structured such that they increase only in line with general inflation based on published indices or statistics. Lease receipts that are structured to increase in line with inflation or that are variable in nature, including leases that vary according to actual rates of inflation or turnover (i.e. contingent rent), are recognised as incurred. [FRS102.20.25-25A] Paragraphs 20.28 to 20.32 above discuss how lease receipts that are structured to increase in line with inflation are identified.

20.42 Costs, including depreciation, are expensed as incurred. The depreciation policy for the leased asset is consistent with normal depreciation policy for assets of that type. Any direct costs associated with the negotiation and arrangement of the lease are added to the carrying value of the asset. They are then recognised as an expense over the lease term and on the same basis on which lease income is recognised. [FRS102.20.26]

20.43 Section 27 is applied to test a leased asset for impairment. [FRS102.20.28]

### Manufacturer or dealer lessors

20.44 Manufacturers or dealers often offer a choice to customers of purchasing or leasing an asset. When an asset is leased under a finance lease, this gives rise to both a selling profit or loss (equivalent to an outright sale at normal selling prices) and finance lease income over the lease term. [FRS102.20.20]

20.45 Sales revenue is the fair value of the leased asset or, if lower, the present value of the minimum lease payments calculated at a market rate of interest. Cost of sales is the cost or carrying amount of the asset less the present value of any expected residual value. The difference between revenue and cost, i.e. selling profit or loss, is recognised as profit or loss in line with the lessor's revenue recognition policy for sales of goods. [FRS102.20.21]

20.46 When an artificially low rate of interest is offered by the lessor, the selling profit is restricted to that achieved using a market rate of interest. Costs of negotiating and arranging the finance lease are expensed when the selling profit is recognised. [FRS102.20.22]

20.47 A manufacturer or dealer leasing an asset under an operating lease does not recognise any selling profit as an operating lease is not the equivalent of a sale. [FRS102.20.29]

### Sale and leaseback transactions

20.48 When an asset is sold and then leased back by the seller this constitutes a sale and leaseback transaction. In this case sales price and lease payments are usually interlinked as they will have been negotiated together. [FRS102.20.32]

20.49 When a sale and leaseback transaction results in a finance lease, the seller-lessee does not immediately recognise any income from the sale in excess of the carrying amount of the asset. The asset's original carrying amount is derecognised and the asset is recognised in accordance with the finance lease guidance. The excess between the consideration paid for the asset and its original carrying amount is deferred and amortised over the lease term. [FRS102.20.33] In our view, it is acceptable for the amortisation of the deferred gain to be presented as a reduction in depreciation expense since the transaction is, in substance, a finance transaction.

20.50 When a sale and leaseback transaction results in an operating lease and the sale is at fair value, the seller-lessee recognises a profit or loss on sale of the asset immediately. If the sales price is less than the fair value, the resultant profit or loss is recognised immediately, unless this is compensated by lease payments at lower than market rate. In this case the loss on sale is deferred and recognised in proportion to the lease payments due over the expected period of use of the asset. If the sales price is greater than the fair value of the asset, the excess is deferred and amortised over the period the asset is expected to be used. [FRS102.20.34]

### Transition

20.51 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 for leases is discussed in paragraphs 35.33 to 35.34 of this publication.

## vs previous UK GAAP

### Applicable standards: SSAP 21, FRS 5, UITF 28

pUK20.1 Classification as a finance lease is presumed if the present value of the minimum lease payments is greater than or equal to 90 percent of the fair value of the asset. FRS 102 considers a wider range of factors for lease classification, which are consistent with those in IAS 17.

pUK20.2 FRS102 includes specific guidance to determine whether a variety of contractual arrangements contains a lease, which was not included in previous UK GAAP. This will result in the accounting for contracts that include the use of assets, such as outsourcing contracts, needing to be revisited.

pUK20.3 UITF 28 contains specific guidance on accounting for operating lease incentives. Lease incentives are spread over the shorter of the lease term and the period ending on the date from which it is expected that the prevailing market rent will be payable. FRS 102 spreads the benefit over the lease term and provides a detailed definition of that lease term, which will include extension options when it is reasonably certain at inception that the lessee will exercise that option.

pUK20.4 For a lessor accounting for finance leases under SSAP 21, the calculation of a constant periodic rate of return may take into account tax payments and receipts, including the effect of capital allowances, when arriving at the net cash investment in the lease. There is no similar provision in FRS 102.

pUK20.5 When accounting for operating lease rentals, lease rentals that are structured to increase by fixed amounts that reflect inflation are accounted for on a straight-line or other systematic basis, in the same way as all other rental payments. FRS 102 allows certain lease rentals that are structured to increase in line with expected inflation to be recognised as incurred. This would apply to both lessees and lessors.

pUK20.6 In an operating lease, some lessors apply interest-based methods of depreciation (e.g. annuity depreciation) to the leased asset; such methods are not permitted under FRS 102.

pUK20.7 A sale and leaseback transaction resulting in a finance lease is generally accounted for as a borrowing, rather than a separate sale and finance lease. As such the carrying value of the asset will remain unchanged with no separate deferral of the excess. Under FRS 102 sale and leasebacks are treated as a sale and a separate leaseback.

## vs EU-IFRS

### Applicable standards: IAS 17, SIC-15, SIC-27, IFRIC 4

IFRS20.1 Under IAS 17, operating lease payments that are structured to increase by fixed amounts (even if they reflect expected inflation) are recognised on a straight-line basis. Contingent rents are defined in IAS 17 and are specifically excluded from minimum lease payments; the same is true in FRS 102. FRS 102, however, allows certain lease rentals that are structured to increase in line with expected inflation to be recognised as incurred. This would apply to both lessees and lessors.

IFRS20.2 SIC-27 provides further guidance on evaluating the substance of certain transactions that involve the legal form of a lease and whether it is appropriate to account for the arrangement as a lease or some form of financing arrangement. FRS 102 does not specifically cover this area although the substance of the arrangement would need to be considered when concluding on what the appropriate accounting for the arrangement would be.



# 21 Provisions and contingencies

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## OVERVIEW OF REQUIREMENTS

- A provision is a liability of uncertain timing or amount.
  - A provision is recognised when an entity has a legal or constructive obligation at a given reporting date as a result of a past event; a transfer of economic benefits in settlement is probable; and the amount of the obligation can be measured reliably.
  - Provisions are measured at the best estimate of the amount required to settle the obligation at the reporting date. This is discounted to present value when material.
  - Reimbursement (e.g. from insurance) is recognised only when its receipt is virtually certain on settlement of the obligation. Reimbursements are not offset against the provision but shown as separate assets. In the income statement, reimbursements may be shown net of the expense related to the provision.
  - Provisions are reviewed at each reporting date and updated to reflect the current best estimate of the liability.
  - An onerous contract is recognised and measured at the present obligation under the contract.
  - A contingent liability is either a possible obligation whose existence is yet to be confirmed or a present obligation for which an outflow of resources is not probable, or the amount of the obligation cannot be estimated reliably.
  - A contingent liability is not recognised as a liability unless acquired as part of a business combination. Contingent liabilities are disclosed in the financial statements when the possibility of an outflow of resources is not considered remote.
  - A contingent asset is a possible asset arising from past events whose existence will be confirmed by the occurrence of a future event not wholly in the entity's control.
  - A contingent asset is not recognised. Disclosure is made when an inflow of economic benefits is considered probable.
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## FRS 102

### Section 21

21.1 This section applies to:

- all provisions and contingencies, except those provisions dealt with elsewhere in FRS 102 (e.g. Section 29 *Income tax*, Section 28 *Employee benefits*);
- onerous contracts not specifically covered elsewhere in FRS 102 (see paragraph 28.42 of this publication for a discussion of the impact of minimum pension funding requirements);
- financial guarantee contracts unless the entity has chosen to apply IAS 39 and/or IFRS 9 (even though not yet adopted) to its financial instruments or has elected under FRS 103 to continue to apply insurance contract accounting to such contracts. [FRS102.21.1,1A]

21.2 This section does not apply to:

- financial instruments (including loan commitments) – see Section 11 *Basic financial instruments* and Section 12 *Other financial instruments issues*;
- reinsurance contracts held by the entity and insurance contracts, reinsurance contracts and financial instruments with a discretionary participation feature issued by the entity that are in the scope of FRS 103. [FRS102.21.1B] See Chapter 36 of this publication.

21.3 Provisions differ from other categories of liability such as trade creditors and accruals. Trade creditors are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier. Accruals are liabilities to pay for goods or services that have been received or supplied but have not been invoiced or formally agreed with the supplier. Although it is sometimes necessary to estimate the amount or timing of payments under accruals, the uncertainty is generally much less than for provisions.

21.4 This section does not include items sometimes referred to as ‘provisions’ but which by their nature are adjustments against asset values, such as depreciation or bad debt provisions. [FRS102.21.3]

#### Executory contracts vs. onerous contracts

21.5 Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. [FRS102.21.2] A contract for the future delivery of goods, when the goods have not yet been received, or employment contracts, when the services have not yet been received, are examples of executory contracts.

21.6 An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it (see paragraph 21.55 of this publication). [FRS102.GL]

#### Financial guarantee contracts

21.7 A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due in accordance with the original or modified terms of a debt instrument. [FRS102.GL] An example would be when one entity within a group guarantees the borrowings of another group entity.

#### Parent company guarantees

21.8 A subsidiary can be exempt from the requirement to obtain an audit if its parent company guarantees all of its outstanding liabilities. Such a guarantee does not meet the definition of a financial guarantee contract as it does not arise from a contract nor is it limited to the default of a specified debtor but, instead, it arises from the application of law and covers all liabilities of the subsidiary.

21.9 Nevertheless, the parent company has a present obligation arising from a past event, i.e. providing the guarantee in law. For this reason it will have to assess the requirement for recognising a provision or making disclosure as a contingent liability under the normal requirements of Section 21.

21.10 Disclosures for such transactions are required not only under the normal requirements of FRS 102.21.14 and FRS 102.21.15 but also under section 479A of the Companies Act. The Companies Act requires disclosure of the existence of such a guarantee regardless of any expectation about economic outflows.



### Discretionary participation feature

21.11 A discretionary participation feature is a contractual right of the investor or policyholder to receive certain types of additional benefit, as a supplement to guaranteed benefits. Those supplementary benefits are likely to make up a significant portion of the total benefits. The amount and timing is at the discretion of the issuer and based on the performance of specific contract(s), specific investment assets or the entity itself. [FRS102.GL]

### Recognition

21.12 A provision is a liability of uncertain timing or amount. [FRS102.GL]

21.13 A provision is recognised when:

- an entity has an obligation as a result of a past event at the reporting date. An obligation can be either a legal or constructive obligation (whereby valid expectations have been raised in other parties as a result of past behaviour);
- it is probable (more likely than not) that an associated transfer of economic benefits will occur; and
- the amount of the obligation can be estimated reliably. [FRS102.21.4]

21.14 A provision is recognised as a liability and as an expense unless the cost is required by FRS 102 to be recognised in the cost of an asset. [FRS102.21.5]

### Past event

21.15 An entity will need to identify which, if any, of its actions are the past event that creates an obligation in the entity.

#### Example 21.1

A claim is raised after the reporting date against a food manufacturer claiming food poisoning relating to a product that had been sold before the reporting date. The past event could be the production of unsafe food or alternatively the sale of a product that does not meet the required standard. It is not the claim being raised.

21.16 It may sometimes be unclear whether certain events have occurred or whether, even when there is certainty over their occurrence, those events resulted in an obligation. An acceptable approach to determine the existence of an obligation for the purpose of recognising a provision or disclosing a contingent liability is to consider whether, based on all the available evidence, it is more likely than not that the events have occurred or that they resulted in an obligation.

#### Example 21.2

Following on from example 21.1, the food manufacturer now disputes that its product caused the food poisoning. The entity will assess its production processes to establish if unsafe food has been produced. The claimant provides evidence that the food poisoning suffered was related to the consumption of the entity's product. When, based on all available evidence, the entity believes that it is more likely than not that the food poisoning was caused by the product there is a relevant past event and the entity has an obligation. The entity would then move on to the second and third criteria for recognition of a provision.

When the available evidence does not support a link between the food poisoning and the entity's product, no obligation exists as at the reporting date.

21.17 If there is an obligation as a result of a past event the entity has no realistic alternative to settling the obligation, which might be either a legal or a constructive obligation. [FRS102.21.6]

### Legal obligation

21.18 While FRS 102 does not provide a definition of a legal obligation, Section 2 *Concepts and pervasive principles* describes it as an obligation that is legally enforceable as a consequence of a binding contract or a statutory requirement. [FRS102.2.20]



### Constructive obligation

21.19 A constructive obligation derives from an entity's actions when:

- by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- as a result the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities. [FRS102.GL]

21.20 The first part of the definition involves the communication of an acceptance of an obligation or responsibility. The communication can be in the form not only of statements or policies but also of past practice. Vague communication will not suffice: it should be something sufficiently specific and strong such that a third party will rightly expect the entity to discharge the responsibility. As a result, management intent alone is not sufficient to create a constructive obligation until such intent is communicated to the third party that will be affected; the key is the expectation of the other party.

21.21 It is not necessary to know the identity of the other party – a general statement to a wider group as a whole may be sufficient, for example in the case of extra-statutory environmental clean-up (when the entity has no legal obligation for clean-up but has published its environmental policies) or when retailers provide refunds beyond their legal requirements arising from warranties. [FRS102.21A.5]

21.22 Obligations that will arise from the future conduct of the business do not satisfy the above criteria even if they are contractual and no matter how likely they are to occur. [FRS102.21.6]

#### Example 21.3

The government brings in changes to the income tax system which will result in Company A needing to retrain all of its sales staff in order to ensure continued compliance. At the year end the retraining has not yet commenced.

The change to the tax system does not represent an obligation for A to retrain staff but is instead concerned with the conduct of its business in the future. Since the training itself has not yet taken place (the obligating event to incur a cost), A does not recognise a provision. [FRS102.21A.8]

21.23 A further example relates to repair and maintenance costs (see paragraph 21.50 of this publication).

21.24 When an entity can avoid future expenditure through its own actions, no provision is made, even if incurring the expenditure is commercially essential. [FRS102.21.6]

21.25 For example, an entity receives a fine and must also incur clean-up costs for unlawful environmental damage: it cannot avoid either cost by any future actions. Similarly, another entity is obliged to rectify damage or contamination caused by its past operation of, for example, an oil rig or a nuclear power station – there is no action it can take to avoid having to put right the effects of operations to date. In both cases an obligation exists as a result of a past event.

21.26 In contrast an entity may, because of commercial pressures or legal requirements, intend or need to incur expenditure to operate in a particular way in the future. For example, it may need to fit smoke filters in a certain type of factory. Since the entity can avoid the future expenditure by its future actions, for example by changing its method of operation or selling the factory, it has no obligation for that future expenditure and no provision is recognised. [FRS102.21.6]

21.27 It is worth noting that the standard accepts that an entity may need to take some rather extreme future actions to avoid expenditure – here, selling the factory – nevertheless an obligation does not arise so long as such actions are within its control.

21.28 This might appear to be inconsistent with the going concern assumption. However, there is no real inconsistency: the key point is that it is assumed that the entity will continue to operate in the future and that the costs of so doing are recognised in the same period – i.e. in the future.

21.29 Probable future operating losses are not provided for since they do not meet the definition of a liability and there is no past event that obliges the entity to fund the losses (e.g. it could sell the operation). [FRS102.21.11B, FRS102.21A.1]

### Probability of outflow of economic benefits

21.30 Once an entity has determined that it has an obligation, it will recognise a provision only if it also meets the other two criteria for doing so – that it is probable (i.e. more likely than not) that it will be required to settle the obligation and that it can measure the obligation reliably.

#### Example 21.4

A customer is recorded on CCTV as having slipped on a shop floor. The customer has suffered some injuries.

An obligating event has occurred, i.e. a wet area of floor was left unsecured in the shop and a customer has slipped over on it.

The entity will need to assess if it is probable that the customer will demand compensation. If the entity assesses it as more likely than not then, subject to being able to measure the amount of compensation reliably, it should provide an amount for that compensation. If it is either not probable that the entity will need to compensate the customer, or the amount of compensation cannot be estimated reliably, the entity should consider disclosure of a contingent liability (see paragraph 21.83 of this publication).

### Initial measurement

21.31 A provision is measured at the best estimate of the amount required to settle the obligation at the reporting date. The best estimate is the amount an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. [FRS102.21.7]

21.32 An entity will consider technological advances and measure the provision based on an expectation of the technology available when the obligation will be settled.

21.33 Any gains from the expected related disposal of assets are specifically excluded from the measurement of a provision. [FRS102.21.8]

21.34 When the provision arises from a single obligation, the individual most likely outcome may be the best estimate of the amount required to settle the obligation. However, other possible outcomes are not ignored: when they are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount. [FRS102.21.7]

#### Example 21.5

An entity is involved in a dispute with the local government over an environmental clean-up. The entity's lawyers advise that there is an 80% chance that the clean-up will cost the entity £2m and a 20% chance that it will need to spend only £1m.

The most likely outcome is that the entity will spend £2m therefore the provision is measured at £2m. It would not be appropriate to recognise a provision at its expected value of £1.6m ( $£2m \times 80\% + (£1m \times 20\%)$ ), since this would not be the entity's best estimate of the cost.

#### Example 21.6

An entity is required to repair a faulty product that has been returned by a customer. It expects that there is a 50% chance that it can repair the equipment after one attempt, a 30% chance that it will take three attempts and a 20% chance that it will take five attempts. Each attempt costs £1m.

The most likely outcome is that the equipment can be repaired in one attempt for £1m, however there are other outcomes that will result in costs of £3m and £5m respectively. In this scenario a provision of £2.4m ( $(£1m \times 50\%) + (£3m \times 30\%) + (£5m \times 20\%)$ ) is recognised as the other outcomes are mostly higher.

21.35 When the provision involves a large population of items, the best estimate of the amount reflects the weighting of all possible outcomes by their associated probabilities. When there is a continuous range of possible outcomes and each point on that range is as likely as any other, the mid-point of the range is used. [FRS102.21.7]

**Example 21.7**

Company A sells widgets with a three year warranty. Experience suggests that:

- 80% of widgets require no warranty repairs
- 10% require minor repairs (cost: 20% of sales price)
- 6% require major repairs (cost: 50% of sales price)
- 4% require replacement (cost: 70% of sales price)

Sales in 20X0 are £1m. Company A estimates its warranty costs to be:

$$(\text{£1m} \times 80\% \times 0) + (\text{£1m} \times 10\% \times 20\%) + (\text{£1m} \times 6\% \times 50\%) + (\text{£1m} \times 4\% \times 70\%) = \text{£78k}$$

A estimates the timing of these warranty costs to be:

- 50% in 20X1
- 30% in 20X2
- 20% in 20X3

Assuming that there are no other risks or uncertainties to be reflected, the present value of the expected cash flows for the warranty provision costs is:

Year	Expected cash (£k)	Discount rate*	Discount factor	Present value (£k)
20X1	(50% x £78k) 39	4%	$1/(1+0.04) = 0.962$	38
20X2	(30% x £78k) 23	5%	$1/(1+0.05)^2 = 0.907$	21
20X3	(20% x £78k) 16	6%	$1/(1+0.06)^3 = 0.840$	13
<b>Total</b>				<b>72</b>

\* Discount rate based on government bonds with the same term as the expected cash flows (4% for 1 year bonds, 5% for 2 year bonds, 6% for 3 year bonds)

A therefore recognises a provision of £72k at the end of 20X0 for widgets sold in 20X0. [FRS102.21A.4]

21.36 In measuring a provision an entity considers the relevance of additional information arising from events occurring after the balance sheet date that are adjusting events. [FRS102.32.5(a) and FRS102.32.7(b)].

**Example 21.8**

An entity is involved in a court case. It has assessed at the reporting date that an obligation exists arising from a past event (environmental damage) and that it is probable that it will incur a remediation cost. However, due to the complex nature of the particular case, even with legal advice the entity has not been able to make a reliable estimate of the potential remediation costs.

The case is settled after the reporting date but before the financial statements are signed. The settlement amount will be taken into consideration when estimating the required level of provision as at the reporting date. [FRS102.32.7(b)]

**Discounting**

21.37 A provision is discounted to present value when the effect of discounting is material. A pre-tax discount rate is used to perform the discounting that reflects current market assessments of the time value of money and risks specific to the liability. [FRS102.21.7]

21.38 There are two methods of dealing with risk in discounting. Either the cash flows are adjusted for risk and a risk-free rate is used or alternatively, the entity uses neutral estimates of the cash flows and makes a risk adjustment to the discount rate. It is not appropriate to adjust both the cash flows and the rate at the same time as this would be double-counting for risk.

21.39 When discounting is applied to assets, such as, for example, when doing an impairment test, risk-adjustment of rates is a comparatively well-understood process. People are familiar with the idea of increasing the discount rate to reflect a risk premium. The higher discount rate produces a lower value for the asset. In the case of a liability the cautious answer is a larger liability. This is what risk-free discounting of the cash flows would produce and both approaches ought to give the same answer. So it is evident that a risk-adjustment to a liability discount rate must involve a reduction in the discount rate.

21.40 In our experience, the first method of using risk-free discount rates and risk-adjusted cash flows will generally be the most appropriate as it will almost always be easier to adjust the cash flows for risk than the discount rate.

21.41 The cash flows are adjusted for the risks specific to the liability rather than generally to the entity. For this reason own credit risk of the entity would generally not be considered when estimating cash flows.

#### Determining a risk-free rate

21.42 An appropriate risk-free rate is, for example, the government bond rate appropriate to the currency and maturity of the obligation in question.

21.43 Most government bonds have interest cash flows throughout their term, whereas what is usually required when measuring a provision is likely to be a rate with a single payment at maturity. Some degree of adjustment to a normal government bond rate may be necessary to deal with this.

#### Reimbursements

21.44 If a reimbursement of some or all of the settlement of a provision is expected (e.g. through insurance), the reimbursement is recognised only when it is virtually certain that reimbursement will be received on settlement of the obligation: it would then be recognised even if at the reporting date the actual amount of settlement is not virtually certain. The reimbursement asset is not offset against the provision and is presented separately in the balance sheet. The reimbursement amount recognised cannot exceed the amount of the provision. In the income statement, the expense related to the provision may be shown net of any reimbursement income. [FRS102.21.9]

#### Subsequent measurement

21.45 Only expenditure for which a provision was created is charged against that provision. [FRS102.21.10]

21.46 For provisions discounted to present value, the periodic unwinding of the discount is recognised as a finance cost in profit or loss. [FRS102.21.11]

21.47 Provisions are reviewed at each reporting date and updated to reflect the current best estimate of the liability. Changes in the level of provision required are recognised in profit or loss unless recognised originally within the cost of an asset.

21.48 Changes in estimate may arise from changes in both the expectation of the level of cash flows required to settle the obligation and the discount rate used. Changes arising from updates to expected cash flows (both in amount and likelihood) are recognised as operating costs or within the cost of an asset. It is less clear if a change in the level of provision arising from a change in the discount rate should be treated in the same way as all other changes, i.e. as an operating cost, within the cost of an asset, or together with the periodic unwinding of the discount as a finance cost. The standard provides no explicit guidance:

- One view is that FRS 102.21.11 is explicit in that only the unwinding of the discount shall be recognised as a finance cost. The 'unwinding' of the discount reflects changes to the value of the provision arising only from the passage of time, not from any change in the discount rate. Consistent with this view, any charge/credit arising from a change in the discount rate would not be included within finance costs. Instead, it would be included within operating costs or as part of the cost of an asset. This treatment is consistent with that required by IFRIC 1.
- An alternative view is that the cumulative effect of a change in discount rate, as well as the unwinding of the discount, should be recognised within finance costs as it represents a change in the estimated finance cost.

21.49 In our view both alternatives are acceptable: an entity should establish an appropriate accounting policy and apply it consistently.

## Application issues

### Repairs and maintenance

21.50 Provisions shall not be recognised for future operating losses. [FRS102.21.11B]

### Owned assets

21.51 As a result, an entity cannot build up a provision for future costs of repairing or maintaining its own property, plant and equipment, regardless of whether major inspections or overhauls are required by law or done within the entity's business cycle. Future repairs and maintenance are not obligations of the entity resulting from past events: they relate to the future operation of the business as they are restoring an asset's service potential. Such costs are accounted for only when incurred and are either capitalised into the carrying value of the related asset (see Chapter 17 of this publication) or written off as operating expenses.

#### Example 21.9

An airline owns an aeroplane engine. Legislation requires an overhaul of the engine after a set number of flying hours. Unless such an overhaul is completed the engine cannot be used.

These costs cannot be provided for in advance as the airline could avoid incurring the overhaul costs by mothballing or selling the engine.

### Leased assets

21.52 When an asset is leased under a finance lease arrangement the principles set out above apply.

21.53 If the lessee is responsible for its maintenance, notwithstanding that this arises from a contractual requirement, then the normal approach to owned assets described above applies: no provision is made. This situation is similar to an asset purchase having been financed by a loan secured on the asset, when the lender requires the asset to be maintained.

21.54 When an asset is leased under an operating lease, provision for maintenance or dilapidations might be required in the lessee's financial statements when the lessee is responsible for maintenance of the asset.

#### Example 21.10

An entity leases a retail shop outlet. It undertakes work to align the new shop with the design of its existing outlets by putting up shelving and decoration. The lease contract requires the entity to return the property in its original condition.

The entity recognises a provision for the expected cost to return the property to its original condition when, and only when, it undertakes the work. It does not build up a provision for the cost over the lease term. It will instead capitalise the discounted amount as leasehold improvements. Putting up the shelving and the decoration is the past event that creates the obligation to remove it at the end of the lease term.

### Onerous contracts

21.55 An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. [FRS102.GL] Unavoidable costs are the lower of the costs of completing the contract and any penalties occurring as a result of terminating the contract. [FRS102.21A.2]

#### Example 21.11

An entity has a contract with its customer to deliver a certain service at a fixed price of £50,000. Due to an unexpected change in the operations of the contract the fixed cost base has increased to £55,000. As a result the contract is considered onerous.

21.56 However, a contract on unfavourable terms is not necessarily onerous.

### Example 21.12

An entity has a contract to provide heating installations to its customer at a fixed price of £12. It has taken out a forward contract to acquire the copper needed for the contract at £10 per unit. Due to a fall in copper prices a unit of copper in the market now costs £7. As the entity is still making a profit on the contract the contract is not onerous even if now less favourable than it originally was.

### Measurement

21.57 The present obligation under the onerous contract is measured at the lower of the cost of fulfilling it and any compensation or penalties arising from the failure to fulfil it. [FRS102.21.11A, FRS102.21A.2]

21.58 Continuing from example 21.11 above, the penalty for early termination of the contract is £6,000. The entity therefore recognises a provision equal to the unavoidable loss, i.e. £5,000.

21.59 In addition to the considerations as set out in paragraph 21.55 above, when assessing which costs are unavoidable and the economic benefits that are expected to be received from the contract, in our view, the entity looks at the benefits arising directly from the contract as well as the wider implications of the contract. For example, a loss-making contract may have been agreed to help generate sufficient volume of business to build capacity in other areas of the entity's operations.

21.60 The boundary between an overall loss-making operation and an onerous contract is at times not clear-cut but it is important that it be established since, as noted above, provision cannot be made for future operating losses. [FRS102.21.11B]

### Example 21.13

An entity operates a number of cinemas. One of the cinemas operates at a loss. The entity has considered all options available to it to close the operations of this location. When doing so it found that the penalties arising from exiting the lease and other related contracts early are higher than the unavoidable costs of running the cinema until the end of the lease term.

21.61 As the loss arises from the ongoing trading of the entity one could argue that recognising a provision would result in providing for future operating losses. However, as FRS 102.21A.2 describes the unavoidable costs as the 'least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it', it seems that provision can be made for the present value of all expected losses until the end of the lease contract.

21.62 In our view, for an onerous lease contract to be provided for, the contract must effectively be an activity in its own right, rather than incidental to the larger business. If the contract is part of an overall loss-making operation the requirement for an impairment review should be considered.

21.63 In example 21.13 above, a provision would be appropriate only if the cinema is a separate cash-generating unit (i.e. an activity in its own right) (see Chapter 27 of this publication) and the entity intends to exit the lease. If the entity intends to extend the lease at the end of the original term and accepts trading at a loss because, for example, of the cinema's contribution to its wider business, then these are no longer unavoidable costs but represent future operating losses that cannot be provided for.

**Example 21.14**

An entity has an operating lease under which it rents all five floors of a building as follows:

Floor A	Empty – to be sub-let with separate entry and security but the sub-lease income will be lower than the amount of rent paid
Floor B	Empty – entity decides to leave the floor empty, even if it could find a sub-lessee
Floor C	Empty – could not be sub-let to an external third party as it is not possible to get separate entry/security, but can be sub-let to another entity within the entity's group
Floor D	Empty – the entity could sub-lease to an external third party but has decided instead to give the existing employees a bit more space and move some of them into the empty space
Floor E	Half the floor is empty

Floor A – The obligation under the lease contract to pay rent for the separable empty floor exceeds the economic benefits the entity will receive under it due to the rental income being lower than the unavoidable rental costs. The contract can be considered onerous in respect of the empty floor and a provision should be recognised for the difference between the expected sub-lease income and the allocation of rental costs for the empty floor. [FRS102.21A.2] The provision can be recognised only from the date on which the entity vacates the floor.

Floor B – Provided the entity could find a lessee it could offset some or all of the costs by recovering them through rental income. Although the standard is not specific regarding benefits that could be received if a certain course of action were followed, we believe that they should be taken into account in assessing the liability under the onerous contract, due to the standard referring to economic benefits expected to be received. A conscious decision not to sub-lease and earn income means that there are no 'unavoidable costs', on a net basis, to the extent that such income could be earned; therefore no onerous contract exists and no provision can be recognised. If the entity is unable to find a tenant, or is restricted by the head-lease from subletting, a provision would be appropriate.

Floor C – The floor cannot be separated and therefore cannot be sub-let. This means that there is no possibility for the entity to have an 'activity in its own right' with regard to this floor. Therefore the costs arising are part of the overall operating activities of the entity. As operating losses cannot be provided for, no provision can be recognised.

Floor D – Similarly to floor B the entity has decided to accept the costs i.e. the entity has made the decision to pay a higher amount of rent per employee than it would need to. Since it could rent out the space, the costs are not unavoidable; rather, it has decided to incur higher ongoing rental costs per employee. Therefore no provision should be recognised as the entity is still using the space.

Floor E – Half of a floor in an office building will not be considered an 'activity in its own right'. Therefore the costs are part of the overall operating costs and no provision can be recognised.

**Self-insurance**

21.64 The term self-insurance refers to those situations when an entity does not take out third-party insurance for claims made against it, for example, customers' accidents on its premises. In some cases these self-insurance arrangements are effected through a captive insurance subsidiary.

21.65 In its own financial statements the captive insurance entity will account for any third-party insurance contract issued to other group entities as an insurance contract reflecting the terms of the contract (see Chapter 36 of this publication).

21.66 In the group accounts that include the captive insurance entity, FRS 102.21.4 applies in the normal way, i.e. a provision is recognised only when the group can identify a past event, expects the outflow to be probable and can measure the obligation reliably as at the reporting date.

21.67 Events may have occurred at the reporting date but not yet have been reported to the entity. In many cases these will be reported shortly after the year-end and will be adjusting post-balance sheet events as they provide evidence of a past event. In some cases they take longer to be reported. For example, a customer that trips up in a retail shop may suffer some internal injury that is not immediately obvious and it may be several months before damages are claimed from the retailer. It may be acceptable to make some appropriate provision for such events, to the extent that it is more likely than not that such events have occurred. In other words, when they are sufficiently common for this to be appropriate, they will be statistically inferred (rather like warranties).



## Levies

21.68 The standard does not include any specific guidance on the accounting for levies which, following the issue of IFRIC 21, is generally understood to be those amounts imposed by government on entities in accordance with legislation, excluding items within the scope of income taxes standards or that arise following a breach of legislation.

21.69 FRS 102.21.4(a) states that a provision is not recognised until an entity has an obligation as a result of a past event. Certain government levy arrangements require entities to pay based on meeting certain conditions at a certain date. In our view, no obligation exists before that date and as such no provision would be recognised. This is consistent with the principles of IFRIC 21.

21.70 For example, the Financial Services Compensation Scheme (FSCS) management expense levy becomes payable if an entity is trading on 1 April of any given year. The obligating event is being in business on 1 April, and hence a provision is recognised on that day.

## Restructuring

21.71 A restructuring is a programme that is planned and controlled by management and materially changes either:

- (a) the scope of a business undertaken by an entity; or
- (b) the manner in which that business is conducted. [FRS102.GL]

21.72 A provision for restructuring is recognised only when the entity has a legal or constructive obligation at the reporting date. A constructive obligation for a restructuring that materially changes the scope or manner of an entity's business exists when the entity:

- (a) has a detailed formal plan for the restructuring covering the part of the business and locations affected, the approximate number and function of employees at risk of redundancy, the expenditure to be undertaken, and the timescale of the restructuring; and
- (b) has raised a valid expectation of the restructuring in those affected either through announcing the major characteristics of the plan or by commencing the restructuring. [FRS102.21.11C,D]

21.73 When a restructuring is announced after the end of the reporting period but before the financial statements are authorised for issue, the announcement, or commencement of implementation of a major restructuring, is a non-adjusting event. [FRS102.32.11(e)]

21.74 Restructuring costs might include termination benefits, the recognition and measurement of which is addressed in Section 28 *Employee benefits* and in paragraph 28.49 of this publication.

21.75 The standard provides no guidance on what form the announcement of the plan for restructuring should take. In our view the announcement need not be made to all the specific parties involved; it will be sufficient to issue a general statement, so long as it is sufficiently detailed to allow all potentially-affected counterparties to assess their position and therefore have a valid expectation of what the plan means for them.

## Measurement

21.76 As the standard does not include specific measurement requirements for restructurings, the general rules in Section 21 apply. Only incremental costs associated directly with the restructuring can be provided for. No provision is allowed for ongoing activities such as:

- future operating losses, unless they relate to onerous contracts;
- training and relocating staff; or
- loyalty bonuses or amounts paid to staff as an incentive to stay.

## Contingent liabilities

21.77 A contingent liability is either a possible but uncertain obligation or a present obligation that is not recognised as a liability since it is either not probable that a transfer of economic benefits will occur, or the amount of economic benefit cannot be measured reliably. [FRS102.21.12]

21.78 Contingent liabilities are recognised as liabilities only when they are acquired in a business combination (see paragraph 19.11 of this publication). Contingent liabilities are required to be disclosed unless the possibility of an outflow of resources is



remote. When an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. [FRS102.21.12]

### Example 21.15

Company A has been sued by a customer but disputes the claim. Company A's lawyers advise as at 31 December 20X0 that it is probable that company A will not be found liable. Company A therefore does not have a present obligation as a result of a past obligating event and does not recognise a provision at 31 December 20X0. Assuming the probability of outflow is not deemed remote, the matter is disclosed as a contingent liability in the accounts. [FRS102.21A.9]

21.79 When a provision is recognised but there is uncertainty remaining over the magnitude of the amounts required to settle the obligation, this uncertain element is not a contingent liability but is addressed instead in the disclosure of the provision. [FRS102.21.14(c)]

### Contingent assets

21.80 A contingent asset is a possible asset arising from past events whose existence will be confirmed by the occurrence of a future event not wholly in the entity's control. [FRS102.21.13]

21.81 Contingent assets are not recognised as assets. Contingent assets are required to be disclosed when an inflow of economic benefits is probable. If an inflow of future economic benefits to the entity becomes virtually certain, the related asset is no longer a contingent asset, and an asset is recognised. [FRS102.21.13]

### Disclosures

21.82 Disclosure of contingent liabilities includes a description of the contingency, an estimate of its financial effect, an indication of timing of any expected outflow, and any reimbursements expected. When it is impracticable to give this disclosure, that fact is stated. [FRS102.21.15]

21.83 Disclosure of contingent assets includes a description and an estimate of the financial effect. When it is impracticable to give this disclosure, that fact is stated. [FRS102.21.16]

21.84 In some extremely rare cases, the disclosures required by this section (including the disclosures required by FRS 102.21.14 for provisions that are not described here) might seriously prejudice the position of the entity in a dispute with other parties. In such cases the disclosure need not be given but instead a general description of the nature of the dispute and the reasons why the necessary disclosure has not been made are given. However, the seriously prejudicial exemption is not available to any UK company in respect of its provisions or contingent liabilities if that disclosure in respect of these items is required by the Companies Act (as set out in Schedule 1 of the Regulations). There would be no similar restriction on availability of the exemption for contingent assets since the Companies Act includes no disclosure requirements for contingent assets. [FRS102.21.17]<sup>1</sup>

21.85 There is no requirement to disclose remote contingent liabilities. However, the Regulations require certain information to be given 'with respect to any other contingent liability not provided for' (see Schedule 1 paragraph 63(2) of the Regulations). It is accepted practice that remote contingencies are, ipso facto, considered to be immaterial and therefore need not be disclosed under the Act, thus confirming the scope of the two sets of requirements. Materiality is specifically mentioned in Schedule 10: 'amounts which in the particular context of any provision of this Schedule are not material may be disregarded for the purposes of that provision' (see Schedule 10 paragraph 10 of the Regulations).

### Transition

21.86 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

<sup>1</sup> FRS 102.21.17 was revised in July 2015 for periods beginning on or after 1 January 2016 (early-adoption is permitted as set out in paragraph INT.7 of this publication) and requires certain additional disclosures when the 'seriously prejudicial' exemption is applied.

## vs previous UK GAAP

Applicable standards: FRS 3, FRS 12, UITF 25, UITF 45

pUK21.1 FRS 12 provides more guidance on accounting for restructurings.

pUK21.2 FRS 3 permits the recognition of a provision for loss on disposal of an operation which would not otherwise be permitted under FRS 12 or FRS 102.

pUK21.3 The principles of FRS 12 are applied when recognising certain employee benefits such as bonus and profit-sharing arrangements or redundancy programmes that are not linked to a restructuring. Such arrangements are now dealt with under Section 28 *Employee benefits*.

## vs EU-IFRS

Applicable standards: IAS 37, IFRIC 5, IFRIC 6

IFRS21.1 IAS 37 provides more guidance on accounting for restructurings.

IFRS21.2 Financial guarantee contracts fall into the scope of IAS 39 and are accounted for as financial instruments. They are measured initially at fair value and subsequently at the higher of the amount determined in accordance with IAS 37 and the amount initially recognised (less, when appropriate, cumulative amortisation recognised in accordance with IAS 18).

IFRS21.3 IFRIC 1.4 clarifies that both changes in the estimated timing or amount of the cash flows expected to settle the obligation and changes to the discount rate are treated in the same way, i.e. added to the cost of the asset. FRS 102 is silent on this.



# 22 Liabilities and equity

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## OVERVIEW OF REQUIREMENTS

- Equity is the residual interest in the assets of an entity after deducting all its liabilities.
  - A financial instrument is usually classified as a financial liability if:
    - it contains a contractual obligation to transfer cash or other financial assets; or
    - it will or may be settled in a variable number of the entity's own equity instruments.
  - Some financial instruments meet the definition of a liability but are classified as equity by exception, e.g. certain puttable instruments.
  - The issue of shares or other equity instruments (including options, rights and warrants) is recognised in equity at fair value of the consideration received, net of issue costs.
  - A capitalisation or bonus issue is the issue of new shares to shareholders in proportion to their existing holdings and does not change total equity, though reclassification within equity may be required.
  - Proceeds from convertible debt or similar compound financial instruments are allocated first to the liability and then to the equity component.
  - The fair value of consideration paid to purchase treasury shares is deducted from equity and no related gain or loss is recognised in profit or loss.
  - Distributions to owners are deducted from equity.
  - Non-controlling interest (NCI) in the net assets of a subsidiary is presented in equity in the consolidated financial statements.
  - Changes in NCI (when the parent does not lose control of the subsidiary) are accounted for in equity. No gain or loss or change in the carrying amounts of assets or liabilities is recognised as a result of such transactions.
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## FRS 102

### Section 22

#### Scope

22.1 This section sets out the principles for the classification of non-derivative financial instruments issued as either equity or liabilities and deals with the accounting for issued compound financial instruments, which, from the issuer's perspective, contain both an equity and a liability component. It also determines when derivative contracts over own equity instruments meet the requirements for equity classification in their own right.

22.2 Section 22 *Liabilities and equity* also addresses the accounting for treasury shares, equity instruments issued and distributions made to the entity's owners. Further, it deals with the accounting for non-controlling interests in consolidated financial statements. [FRS102.22.1].

22.3 Section 22 applies to all FRS 102 adopters, regardless of the FRS 102/IAS 39/IFRS 9 accounting policy choice made under Sections 11 *Basic financial instruments* and 12 *Other financial instruments issues* for the recognition and measurement of financial assets and liabilities.

22.4 The principles of Section 22 apply to all financial instruments, except for the following:

- (a) investments in subsidiaries, associates and joint ventures – see Section 9 *Consolidated and separate financial statements*, Section 14 *Investments in associates* and Section 15 *Investments in joint ventures* respectively;
- (b) rights and obligations of employers under employee benefit plans – see Section 28 *Employee benefits*;
- (c) contingent consideration payable by the acquirer in business combinations – see Section 19 *Business combinations and goodwill*;
- (d) share-based payments (except that treasury shares issued, purchased, sold or cancelled in connection with share-based payments are accounted for under this section) – see Section 26 *Share-based payment*;
- (e) financial guarantee contracts – see Section 21 *Provisions and contingencies*; and
- (f) insurance contracts issued, reinsurance contracts issued or held and financial instruments issued with a discretionary participation feature – see FRS 103. [FRS102.1.6, FRS102.22.2]

#### Classification of a financial instrument as liability or equity – basic principles

22.5 For a general definition of a financial instrument, refer to Chapter 11.

22.6 Section 22 provides the following definitions of equity and financial liabilities:

- Equity is the residual interest in the assets of an entity after deducting all its liabilities. Equity includes investments by the owners of the entity, plus or minus retained profits or losses, minus distributions to owners. [FRS102.22.3]
- A financial liability is any liability that is:
  - (a) a contractual obligation:
    - i. to deliver cash or another financial asset to another entity; or
    - ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
  - (b) a contract that will or may be settled in the entity's own equity instruments and:
    - i. under which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
    - ii. that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. [FRS102.22.3]

22.7 FRS 102 has little in the way of additional guidance regarding the application of these definitions in practice. It is the substance of the contractual terms rather than the legal form that governs the classification. For example, some instruments issued in the legal form of shares will nevertheless need to be classified as liabilities for accounting purposes.

22.8 The classification of financial instruments issued can be a complex accounting area in practice, and one that requires detailed consideration of the instrument's contractual terms. Nonetheless, in the absence of any share settlement clauses (see paragraph 22.16 of this publication), the overriding question is simply whether the issuer has an unconditional right to avoid paying cash (or another financial asset). A contractual obligation to pay cash may relate to the principal amount and/or interest or dividend payments. If such an obligation exists, then either part or the whole of the financial instrument should be recognised as a liability.

22.9 When only part of an issued instrument is recognised as a liability, the instrument is a compound financial instrument. The total issue proceeds are allocated between the liability and equity components, as described later in this chapter.

22.10 The general principle in paragraph 22.8 above remains true if the instrument contains a contractual obligation to deliver cash (or another financial asset) which depends on the outcome of an uncertain future event that is beyond the control of both the issuer and the holder of the instrument.

22.11 A financial instrument that does not give the issuer the unconditional right to avoid making payments is a financial liability (in whole or in part) unless:

- the contingent settlement provision under which payment is to be made is not genuine; or
- the issuer can be made to settle in cash or another financial asset only in the event of its own liquidation. In our view, this exception applies only to the extent that liquidation is within the entity's control; or
- the instrument is classified as equity by exception under a specific exemption granted by Section 22 (see also paragraph 22.21 of this publication). [FRS102.22.3A]

22.12 In our experience, it is rare for contracts to include settlement provisions that are not genuine. In our view, this would only be the case if the settlement clause had no economic substance and could be removed from the contract without either party requiring financial compensation, or an amendment to other terms and conditions of the contract.

22.13 When assessing whether an entity has an unconditional right to avoid delivering cash, the role of the entity's shareholders requires careful consideration. In our view, a distinction should be drawn between, on the one hand, instances when the shareholders participate in the normal governance process of the entity (and thus should be regarded as forming part of the entity) and, on the other hand, circumstances when each shareholder acts as an individual investor. An example of the former situation is when shareholders routinely approve the payment of dividends on ordinary shares during the Annual General Meeting. In that case, we believe that the approval of the dividend is within the control of the entity as, for the purpose of that decision, the shareholders act as a body on behalf of the entity. The reverse is true when shareholders act as individual investors, for example when deciding to dispose of their individual shareholdings, whether through exercise of a put option or sale of the shares to a third party acquirer. Each situation will need to be considered separately based on the relevant facts and circumstances.

22.14 Members' shares in co-operative entities and similar instruments are equity when the entity has an unconditional right to refuse redemption of the members' shares, or redemption is unconditionally prohibited by local law, regulation or the entity's governing charter. [FRS102.22.6]

### **Contractual obligation to deliver cash – applying the basic principles in practice**

22.15 An obligation to deliver cash can often arise as a result of contractual terms in regards to either:

- redemption clauses; or
- distribution clauses.

Common examples of each of these types of clauses are considered below.

#### **Common redemption clauses**

22.16 If an instrument is redeemable at a point in time (e.g. a term note), at the option of the holder or on the occurrence of an event that is outside the control of the issuer, then it is a liability or has a liability component. Conversely, if an instrument is redeemable solely at the issuer's option or on the occurrence of an event that the issuer can avoid, then this is not an indicator of a liability.

22.17 The following table lists some redemption clauses commonly seen in practice and explains our view as to whether these terms alone are indicative of a financial liability component.

Clause	Indicative of a financial liability component?
The preference shares are redeemable on liquidation of the entity. The entity has no predetermined liquidation date.	No – Liquidation of the entity (and therefore redemption of the preference shares) is generally within the entity's control.
The preference shares are redeemable if the entity goes into administration or receivership.	Yes – Even though 'voluntary' receivership is possible, such procedures are generally outside the entity's control.
The preference shares are redeemable in the event of a takeover of the entity.	Yes – A takeover or sale (no matter how remote) can happen in a hostile situation. Except in the rare situation when the target entity must agree to the change of control, we would consider a takeover or sale to be outside the entity's control.
The preference shares are redeemable in the event of an initial public offering (IPO).	No – Given that the entity would generally need to start the process, we consider an IPO to be within the control of the entity and thus avoidable. It is generally difficult to envisage circumstances in which a 'hostile' IPO could take place.
The preference shares are redeemable in five years' time except if the entity has listed before then.	Yes – It is not within the entity's control whether the listing will be successful. Therefore, it is not certain that the entity can avoid the obligation to redeem the preference shares in five years' time.
The preferences shares are redeemable if the entity breaches one of its debt covenants (e.g. interest cover or debt/equity ratio).	Yes – In our view breaches of debt covenants are outside the entity's control.
The preference shares are redeemable in the case of adverse changes in tax law (or adverse regulatory changes etc.). The directors consider the likelihood of such adverse changes to be remote.	Yes – A change in tax law (or regulatory change) is outside the entity's control. Even if considered remote, the risk of a change in tax law is nevertheless genuine (see paragraph 22.11 above).
A subsidiary issues preference shares to its parent. The preference shares are redeemable at the holder's option. Both the subsidiary and the parent entity have the same board of directors.	Yes – This is indicative of a liability in the subsidiary. Each entity's board of directors has a fiduciary duty to act independently in the interests of that entity. Therefore, redemption of the preference shares is outside the subsidiary's control.
A subsidiary issues preference shares to its parent. The shares are redeemable at the holder's option, but the parent entity has given a letter of undertaking to the subsidiary that it will not ask for redemption of the shares.	Yes – A letter of undertaking by the holder that it will not exercise the put option is unlikely to be legally enforceable. It is therefore generally insufficient to warrant classification of the preference shares as equity rather than a financial liability.

#### Common distribution clauses

22.18 Distributions may be for a fixed amount, a fixed percentage or a variable amount. However, the key question is whether the issuing entity can avoid making the distribution. A financial instrument with unavoidable distributions is indicative of a liability component.

22.19 The following table lists some distribution clauses commonly seen in practice and explains our view as to whether these are indicative of a financial liability component.

Clause	Indicative of a financial liability component?
Preference shares carry a 6 percent fixed rate dividend. The directors have the discretion to defer the payment indefinitely after having given due consideration to the level of profits.	No – The entity has no contractual obligation to make dividend payments. Indeed, the entity could choose to defer payment indefinitely. In our view, it is irrelevant to the analysis whether payment of the dividends is likely to occur in practice.

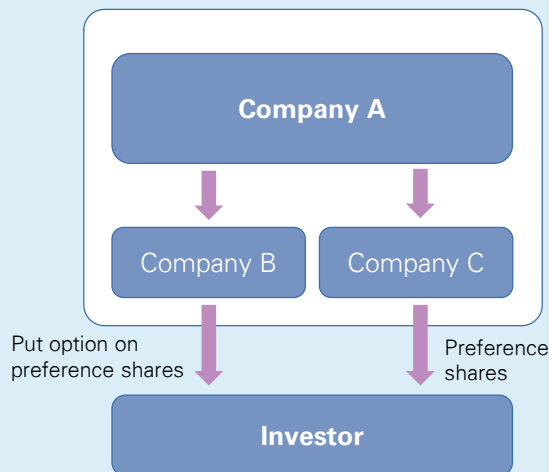
<p>Preference shares carry a mandatory 6 percent fixed rate dividend payable subject to the availability of distributable profits. The entity currently has no distributable reserves and is expected to remain loss-making for the next few years.</p>	<p>Yes – In our view, the potential inability to settle the obligation due to insufficient distributable reserves or other statutory restrictions does not negate the existence of a contractual obligation to make payments. Therefore, this distribution clause is indicative of a financial liability component.</p>
<p>The preference shares carry a 6 percent dividend payable at the directors’ discretion. However, if no dividend is paid on the preference shares in any one year, penalty interest of 10 percent per annum will be rolled up and charged on the unpaid amounts. Further, no ordinary dividend can be paid until all arrears on the preference shares have been settled (dividend stopper clause). Non-payment of an ordinary dividend in any year would have a detrimental impact on the entity’s share price.</p>	<p>No – Despite the economic compulsion to pay the preference dividend, the entity has no contractual obligation to make payments. Indeed, the entity has the discretion to defer payment of dividends and penalty interest indefinitely.</p>

**Consolidated and individual financial statements**

22.20 In consolidated financial statements the classification of financial instruments issued sometimes differs from their classification in the individual financial statements of the issuing entity, as additional terms and conditions agreed by other members of the consolidated group need to be taken into account.

**Example 22.1**

Company A is the parent company of subsidiaries B and C. Company C issues non-redeemable preference shares with discretionary dividends to an investor outside the group. Company B writes a put option on the preference shares issued by C, permitting the holder to sell the preference shares to B for cash.



In its individual financial statements, C classifies the preference shares as equity because it does not have a contractual obligation to redeem the shares or to pay dividends.

Conversely, the group as a whole has a contractual obligation to buy back the preference shares because of the put option written by Company B. As a result, the preference shares are classified as a liability in the consolidated financial statements.

**Equity classification by exception**

22.21 Some financial instruments that meet the definition of a financial liability are nevertheless classified as equity by exception (under a specific exemption granted by Section 22) because they represent the residual interest in the net assets of the entity. Equity classification by exception applies to two categories of financial instrument, puttable instruments and instruments that impose an obligation only on liquidation, subject to the fulfilment of certain conditions.

**Puttable instruments**

22.22 These are financial instruments that:



- are automatically redeemed or repurchased by the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder; or
- give the holder the right to 'put' the instrument back to the issuer for cash or other financial assets.

22.23 Prima facie, puttable instruments meet the definition of a financial liability because the issuer is required to redeem for cash as a result of an event outside its control. However, puttable instruments are classified as equity by exception if the following specific conditions are all met:

- if the entity is liquidated, the holder is entitled only to a pro rata share of the entity's net assets after deducting all other liabilities;
- the instrument is in a class of instruments with identical features that is subordinate to all other classes of instrument;
- apart from the contractual obligation for the issuer to repurchase or redeem the instrument, it does not contain a contractual obligation to deliver or exchange cash or financial assets or liabilities under conditions unfavourable to the entity and it is not a contract that will or may be settled in the entity's own equity instruments; and
- the total expected cash flows attributable to the instrument over its life are based on the profit or loss, change in recognised net assets or change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument itself). [FRS102.22.4(a)]

#### Instruments imposing an obligation only on liquidation

22.24 As explained in paragraph 22.11 of this publication, obligations arising only on liquidation generally do not trigger financial instrument classification, as liquidation would normally be within the entity's control. However, in some cases, liquidation of an entity is pre-ordained (i.e. limited life entities) or outside the entity's control (e.g. one of the investors can force liquidation in its capacity as investor) and such redemption clauses are therefore generally indicative of a financial liability. Nevertheless, instruments (or components of instruments) that impose an obligation only on a liquidation outside the entity's control are classified as equity by exception if:

- the entity's obligation (arising only on liquidation) consists in delivering a pro rata share of its net assets to the instrument holder; and
- the instruments are subordinate to all other classes of instruments issued by the entity. [FRS102.22.4(b)]

22.25 The distinction between a puttable instrument and one that imposes an obligation only on liquidation lies in the timing of the settlement of such obligations. A puttable instrument may be exercised prior to the liquidation of an entity.

22.26 The rules for equity classification by exception are fairly narrowly drawn as a number of specific criteria must be met. The following are examples of instruments that do not meet the restricted scope of the classification exception and would therefore fall to be classified as liabilities (in part or in whole) rather than equity:

- the distribution of net assets on liquidation attributable to the instrument is subject to a cap/maximum amount;
- in respect of a puttable instrument, when the put option is exercised the holder receives an amount that is not calculated based on a pro rata share of the net assets of the entity;
- the entity is obliged to make a payment to the holder before the puttable event or liquidation, e.g. a mandatory dividend;
- preference shares that provide for redemption at a fixed or determinable amount, either automatically at a fixed or determinable date in the future or at the option of the holder.

22.27 A puttable instrument issued by a subsidiary and classified as equity in the subsidiary's financial statements is treated as a liability in the consolidated financial statements. [FRS102.22.5]

22.28 Puttable instruments and instruments imposing an obligation only on liquidation are particularly prevalent in certain sectors or industries, e.g. partnerships or investment funds. For this reason, some SORPs (e.g. the Limited Liability Partnership SORP) have supplemented FRS 102 with additional guidance on how the above requirements should be applied by entities within their remit.

### Instruments to be settled in own equity

22.29 A contract to be settled by the entity issuing its own equity instruments does not generally include a direct obligation on the part of the issuer to deliver cash or another financial asset. Nevertheless, such contracts may need to be classified as financial liabilities depending on the terms of the equity settlement. Indeed, Section 22 imposes additional classification requirements here, which apply to both derivative and non-derivative instruments settled in own equity. Thus, a contract that will or may be settled in the issuer's own equity instruments is a financial liability if:

- it includes a contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
- it will or may be settled other than by the exchange of a fixed amount of cash (or another financial asset) for a fixed number of the issuer's own equity instruments. [FRS102.22.3(b)]

These additional classification criteria for instruments settled in own equity are commonly referred to as the 'fixed-for-fixed' requirement.

22.30 The following examples illustrate how the requirements for instruments settled in own equity are applied in practice.

#### Example 22.2

Company X issues a bond at its face value of £100,000. The bond carries no coupon and will be settled in 2 years' time through conversion into ordinary shares to the value of £120,000 (as at the settlement date).

From the holder's perspective the return is fixed in the same way as if the instrument were settled in cash. Based on the Section 22 requirements, X must classify the bond as a liability, despite the fact that it will not be settled in cash.

#### Example 22.3

In a variation on example 22.2, Company Y also issues a bond for £100,000. The bond carries no coupon and will be settled in 2 years' time through conversion into 20,000 ordinary shares.

The bond issued by Y meets the requirements for equity classification as there is no obligation for Y to deliver cash or a variable number of equity instruments.

22.31 Derivatives over own equity (e.g. share options and warrants over ordinary shares) meet the Section 22 definition of equity if and only if they can be settled solely by the issuer receiving or delivering a fixed number of its own equity instruments for a fixed amount of cash (or another financial asset). This is commonly referred to as 'gross physical settlement'.

22.32 Conversely, a share option or warrant that can be settled net in cash ('net cash settlement') breaches the requirements for equity classification in the issuer's financial statements, even if net cash settlement is solely at the issuer's discretion. Instead, the issuer is required in these cases to account for the share options or warrants as derivatives under Section 12 (or IAS 39/IFRS 9, if either of these options has been chosen for financial instruments accounting).

#### Anti-dilution clauses

22.33 In some cases, the number of shares that may be issued varies to take into account changes in the entity's share capital structure. For example, a company has issued an instrument to be settled in a fixed number of equity shares. However, a clause in the agreement provides that the number of equity shares to be issued will be adjusted for the dilutive effect of any future issues of equity shares to existing shareholders at a discount, for example as a result of a rights issue. Similarly, in the event of a bonus issue or share split, there will be a consequential adjustment to the conversion ratio. In our view, clauses such as those described above that exist solely to prevent dilution (commonly referred to as 'anti-dilution' clauses) do not breach the 'fixed-for-fixed' requirement and therefore do not result in financial liability classification.

### Recognition and measurement of financial instruments

22.34 The classification of a financial instrument as either liability or equity determines the initial and subsequent measurement of the instrument. Financial instruments classified as liabilities are accounted for under either Section 11 or Section 12 of FRS 102, as appropriate, unless the entity has elected to use IAS 39 or IFRS 9 accounting. Refer to Chapters 11 and 12 of this publication.

22.35 Financial instruments classified as equity are accounted for under Section 22, as set out below.

#### Issue of shares or other equity instruments

22.36 Shares and other equity instruments (e.g. warrants or share options meeting the definition of equity) are recognised initially when the instruments are issued and another party is obliged to provide cash or resources in exchange for those instruments. If cash or other resources are received by the entity before the issuance of equity instruments, the consideration received and a corresponding increase in equity are recognised in the financial statements, provided the entity cannot be obliged to repay the consideration. When equity instruments have been subscribed for but not yet issued or called up, there is no change to equity unless the cash or other resources have been received. [FRS102.22.7]

22.37 Equity instruments issued are measured at the fair value of the cash or other resources received, net of direct costs of issuing the instruments. The amount thus recognised is discounted to present value if the payments are deferred and the effect of discounting is material. [FRS102.22.8]

22.38 Equity transaction costs are treated as a deduction from equity, net of any related income tax benefit. [FRS102.22.9] The definition of transaction costs is the same as that in respect of financial assets and financial liabilities in the scope of Sections 11 and 12. Further guidance on this area is provided in paragraphs 11.58 and 11.59 of this publication.

22.39 The presentation of individual components of equity is a matter of applicable local law; for example, separate presentation of share capital and share premium is required in the UK under the Companies Act. [FRS102.22.10]

22.40 Equity instruments issued on exercise of options, rights, warrants or other similar derivative instruments are accounted for in the same way as described above, regardless of whether the derivatives themselves were previously classified as equity. [FRS102.22.11]

#### Distributions to owners

22.41 Dividends and other distributions to holders of equity instruments (referred to as 'owners' in Section 22) are deducted directly from equity. [FRS102.22.17]

22.42 Under UK company law, distributions can be made only out of profits available for that purpose. The determination of an entity's distributable profit is subject to complex legal requirements, which are outside the scope of this publication.

22.43 In our view, a liability for dividend payable should be recognised only when the entity has an obligation to pay the dividend, i.e. at the point when the dividend has been appropriately authorised and is no longer at the entity's discretion.

22.44 If assets other than cash are distributed, the fair value of the assets distributed is disclosed unless the ultimate control of the assets is unchanged. [FRS102.22.18]

#### Capitalisation or bonus issues of shares and share splits

22.45 A bonus issue or capitalisation is the issue of new shares to existing shareholders in proportion to their existing holdings. A share split is the dividing of an entity's existing shares into multiple shares. Bonus issues and share splits do not change total equity but may require a reclassification within equity depending on applicable legal requirements. Under UK legislation, a bonus issue may be out of certain capital or reserve accounts, for example, retained earnings or share premium. [FRS102.22.12]

### Convertible debt and similar compound financial instruments

#### Basic principles

22.46 Some financial instruments issued, commonly referred to as 'compound instruments', contain both liability and equity components under one single contract. A typical example is that of debt convertible into a fixed number of ordinary shares of the issuer.

22.47 Convertible debt usually carries a lower coupon than non-convertible debt, as the holder has the added sweetener of the conversion option. The issuer's contractual obligation to make interest payments and redeem the principal (in the case of non-conversion) represents the liability component, whereas the conversion option is the equity component.

22.48 For convertible debt to meet the definition of a compound financial instrument, the conversion option must comply with the criteria for equity classification. As discussed in paragraph 22.29 of this publication, this means that the option can be

settled only by the entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash. In our view, the fixed-for-fixed requirements are not met in the following examples:

- The number of equity instruments delivered on conversion depends on the share price at the conversion date.
- The convertible debt is denominated in a foreign currency (i.e. a currency other than the functional currency of the issuer).
- The convertible bond includes a cash settlement option for the holder and, as a result, the conversion option may be settled other than by the exchange of a fixed amount of cash for a fixed number of equity instruments.

Consequently, in our view, instruments with the above conversion features are financial liabilities in their entirety. See paragraph 22.33 of this publication for our views on the effect of anti-dilution clauses.

22.49 Another example of a compound instrument is a preference share that is redeemable either at a fixed future date or at the option of the holder (liability component), but which has dividends payable at the discretion of the issuer (equity component).

22.50 Perpetual debt instruments give the holder the right to a constant stream of mandatory interest payments in perpetuity, i.e. the principal will never be redeemed. Assuming that there is no conversion right, additional discretionary cash flows, or similar rights that would represent an equity component, these perpetual debt instruments are likely to be liabilities in their entirety rather than compound instruments. Indeed, on the assumption that the instrument pays a market rate of interest, the present value of the perpetual stream of interest payments is equal to the initial issue proceeds.

#### Accounting for compound instruments

22.51 The entity issuing the compound instrument allocates the proceeds between the respective liability and equity components, which are then accounted for separately ('split accounting'). To determine the allocation, the fair value of the liability component is determined as the fair value of a similar liability with no conversion feature, with the remainder of the proceeds allocated to the equity component of the instrument. Transaction costs are split between the liability and equity components in a manner consistent with the allocation of the proceeds. [FRS102.22.13]

22.52 The liability and equity split of the instrument is not revised subsequently after initial recognition. [FRS102.22.14]

22.53 After initial recognition the liability component is accounted for either as a 'basic financial instrument' in accordance with Section 11 or as an 'other financial instrument' in accordance with Section 12, as appropriate. [FRS102.22.15] The equity component is not remeasured after initial recognition.

#### Example 22.4

##### Convertible debt

On 1 January 20X8 Company Y issues 100 convertible bonds. The bonds are issued at par with a face value of £900 per bond and have a five-year term. Y receives issue proceeds totalling £90,000 and no upfront issue costs are incurred. Interest is payable annually in arrears at a rate of 5%. Each bond is convertible, at the holder's option, into 5 ordinary shares at any time up to maturity. At the time the bonds are issued, the market interest rate for similar debt without a conversion option is 7%.

On initial recognition of the convertible debt, the liability component is valued first, and the difference between the total issue proceeds and the fair value of the liability component is assigned to the equity component. The fair value of the liability component is calculated by determining the present value using a discount rate of 7%. The calculations and journal entries are illustrated below.

	£
Present value of principal at the end of five years (a)	64,169
Present value of interest payable annually in arrears for five years (b)	18,451
<b>Fair value of liability component</b>	<b>82,620</b>
Equity component (balancing figure)	7,380
<b>Total issue proceeds</b>	<b>90,000</b>

Y records the following journal entry on 1 January 20X8:

	Dr	Cr
	£	£
Cash	90,000	
Financial liability		82,620
Equity		7,380

(a) Present value of principal at the end of five years:  $£90,000/(1.07)^5 = £64,169$

(b) Present value of interest payable annually in arrears for five years: To calculate the present value of this annuity, future payments are discounted by the annual rate of interest (i) using the following formula:

$$\text{Present value} = \frac{\text{Coupon}}{i \times [1 - 1/(1 + i)^5]} \quad \text{i.e.} \quad \frac{£4,500}{7\% \times [1 - 1/(1.07)^5]} = £18,451$$

Assuming the liability component meets the Section 11 definition of a basic debt instrument, it is subsequently accounted for at amortised cost using an effective interest rate of 7%. A finance charge of 7% is recognised in each period. 5% of the charge is received in cash and the remaining 2% is added to the outstanding liability component. The liability component will thus accrete up to the redemption amount of £90,000 by 31 December 20Y2. The equity component is not remeasured after initial recognition.

If the conversion option is exercised, Y recognises the equity instruments issued and derecognises the liability component. As further explained in paragraphs 11.114 to 11.115 of this publication, FRS 102 does not clarify at what amount these equity instruments should be recognised. However, the generally accepted view is that no gain or loss is recorded on conversion if the debt to equity conversion is in accordance with the original terms of the debt instrument.

### Treasury shares

22.54 The term 'treasury shares', as applied by Section 22, refers to issued equity instruments of an entity that have subsequently been reacquired either:

- directly by the issuing entity; or
- by an Employee Share Ownership Plan ('ESOP') or employee benefit trust whose assets, liabilities and transactions are brought into the issuing entity's financial statements (see paragraph 9.19 of this publication); or
- by any member of the consolidated group in the consolidated financial statements.

22.55 The use of the term 'treasury shares' for accounting purposes is thus different from the Companies Act definition (section 724), which uses that term only for shares reacquired directly by the issuing entity.

22.56 Under Section 22, the fair value of consideration paid to acquire treasury shares is deducted directly from equity, as an entity's own equity instruments cannot be recognised as financial assets. Further, no gain or loss is recognised in profit or loss on the purchase, sale, transfer or cancellation of treasury shares, given that these are transactions with the entity's shareholders in their capacity as owners. [FRS102.22.16]

22.57 Under UK law, if the proceeds of sale of a treasury share held directly by the issuing entity exceed the price paid by the entity, the excess is recognised as additional share premium. This requirement to recognise additional share premium does not apply to treasury shares held indirectly, e.g. through an ESOP or employee benefit trust.

### Reclassification of financial instruments issued

22.58 The classification of an instrument as either equity or financial liability is determined on initial recognition and generally not revised subsequently. However, in our view, the initial assessment should be reconsidered, and a reclassification may be required, if the contractual terms of the financial instrument are amended (e.g. renegotiation of the terms between the issuer and holder of the instrument). Further, in our view, reassessment is permitted when the effective terms of the instrument have changed. An example of the latter situation is that of a preference share that gives the holder the right to put the

instrument back to the issuer during an initial period only. If the put option expires unexercised, the preference shares become irredeemable. See paragraphs 11.114 to 11.115 of this publication for guidance on the accounting for the reclassification of an instrument from financial liability to equity.

### **Non-controlling interest and transactions in shares of a consolidated subsidiary**

22.59 A non-controlling interest is defined as the equity in a subsidiary that is not attributable, either directly or indirectly, to the parent company. [FRS102.GL]

22.60 In consolidated financial statements, a non-controlling interest in the net assets of a subsidiary is included in equity. Changes in the percentage of a parent's ownership interest in a subsidiary that do not result in loss of control are accounted for as equity transactions, and no gain or loss is recognised. In addition, the subsidiary's net assets (including goodwill) included in the consolidated financial statements are not adjusted as a result of such transactions. The only adjustment relates to the carrying amount of the non-controlling interest, which is updated for the change in the parent's interest in the subsidiary's net assets. Any resulting difference between the remeasurement of non-controlling interest and the fair value of the consideration paid or received is recognised directly in equity. See also paragraphs 9.29 to 9.34 and 19.24 of this publication. [FRS102.22.19]

### **Transition**

22.61 An exemption from retrospective application on first-time adoption of FRS 102 from certain requirements of Section 22 (relating to compound financial instruments) is available, as discussed in paragraph 35.24 of this publication.

## vs previous UK GAAP

Applicable standards: FRS 2, FRS 25, UITF 32, UITF 38, UITF 39

pUK22.1 Under FRS 25 an entity that has an obligation (e.g. under a written put option) to purchase its own shares for cash must record a liability at the present value of the redemption amount, even if the instrument is classified as equity. There is no equivalent requirement under FRS 102 and therefore, in our view, such gross presentation is not required.

pUK22.2 The remaining principles in FRS 102 are broadly consistent with FRS 25 but FRS 102 contains less guidance on how to apply these principles.

pUK22.3 Under previous UK GAAP, when a group increases its interest in a non-wholly owned subsidiary, the identifiable assets and liabilities of the subsidiary are revalued to fair value for the purpose of the goodwill calculation only. Additional goodwill is recognised on the increase in interest. When a group decreases its interest in a subsidiary without losing control, any gain or loss on disposal is recognised in the consolidated profit and loss account.

pUK22.4 Previous UK GAAP does not have a requirement to disclose the fair value of non-cash assets distributed to shareholders.

## vs EU-IFRS

Applicable standards: IAS 27, IAS 32, IFRIC 2, IFRIC 17, IFRIC 19

IFRS22.1 Under IAS 32 an entity that has an obligation (e.g. under a written put option) to purchase its own shares for cash must record a liability at the present value of the redemption amount, even if the instrument is classified as equity. There is no equivalent requirement under FRS 102 and therefore, in our view, such gross presentation is not required.

IFRS22.2 The remaining principles in FRS 102 are broadly consistent with IAS 32 but FRS 102 contains less guidance on how to apply these principles.

IFRS22.3 IFRIC 17 requires a liability for certain non-cash asset distributions to be recognised, initially and until settlement date, at the fair value of the assets to be distributed. IFRIC 17 also requires any changes in the measurement of the liability to be recognised in equity. At the date on which the distribution occurs (i.e. the settlement date), any difference between the fair value of the assets distributed and their carrying amount in the financial statements is recognised as a separate line item in profit or loss. FRS 102 requires only disclosure of those fair value amounts. It does not require the liability to be recognised at the fair value amount and does not require a profit or loss on distribution to be recognised.

IFRS22.4 EU-IFRS does not provide specific guidance on the treatment of consideration received for new shares before the shares have been issued, or vice versa.

# 23 Revenue

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## OVERVIEW OF REQUIREMENTS

- This section applies to revenue arising from the sale of goods, rendering of services, construction contracts and the use by others of assets generating interest, royalties or dividends.
  - Revenue is measured at the fair value of the consideration received or receivable. This takes into account trade discounts, early settlement discounts and volume rebates.
  - Revenue excludes amounts collected on behalf of third parties (such as sales taxes).
  - When cash payments are deferred and constitute an element of financing, the fair value of consideration is the present value of all future receipts.
  - Revenue is not recognised from transactions in which similar goods or services are exchanged or transactions which lack commercial substance.
  - Revenue from the sale of goods is recognised when the significant risks and rewards of ownership are transferred, continuing managerial involvement is not indicative of control or ownership, the amount of revenue and the related costs can be measured reliably and it is probable that the benefits of the transaction will be received by the entity.
  - Revenue associated with the rendering of services is measured based on the percentage of completion of the transaction when the amount of revenue, costs and stage of completion can be measured reliably and it is probable that the benefits of the transaction will be received by the entity.
  - If the outcome of a construction contract can be measured reliably, revenue is recognised according to the stage of completion.
  - Interest income is recognised using the effective interest method.
  - Royalty income is recognised on an accruals basis.
  - Dividend income is recognised when the right to receive payment has been established.
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## FRS 102

### Section 23

23.1 This section applies to revenue arising from the sale of goods, rendering of services, construction contracts and the use by others of the entity's assets to generate for it interest, royalties or dividends. Revenue or other income arising from the following sources is covered elsewhere in FRS 102:

- lease agreements – see Section 20 *Leases*;
- income such as dividends from equity-accounted investments – see Section 14 *Investments in associates* and Section 15 *Investments in joint ventures*;
- fair value movements and disposal of financial assets and liabilities – see Section 12 *Other financial instruments issues*;
- movements in fair value of investment property – see Section 16 *Investment property*;
- movements in fair value and recognition of biological assets and agricultural produce – see Section 34 *Specialised activities*; [FRS102.23.2] and
- revenue or other income arising from transactions and events dealt with in FRS 103. [FRS102.23.2A]

The criteria used to determine when revenue can be recognised may also apply to other transactions, such as the disposal of a piece of property, plant and equipment. [FRS102.17.29]

#### Measurement

23.2 Revenue is measured at the fair value of consideration received or receivable. This takes into account any trade discounts, prompt settlement discounts or volume rebates offered. [FRS102.23.3]

#### Example 23.1

Company B sells goods and grants a 5% rebate to each customer that purchase goods with a sales value of at least £1,000,000 during a calendar year.

In our view, if B concludes that it is probable that a particular customer will buy goods worth £1,000,000 or more in the qualifying period, based on its past experience and current year's forecasts, the amount of revenue recognised on each sale during the year should be reduced to reflect the 5% discount, i.e. the fair value of the consideration receivable.

23.3 Amounts collected on behalf of third parties, such as sales taxes, goods and services taxes and value added taxes, are not classified as revenue. In an agency relationship, only the amount of commission is recognised as revenue by the agent. [FRS102.23.4]

23.4 An agent is an entity that is not exposed to the significant risks and rewards associated with the sale of goods or the rendering of services. Indicators that an entity is acting as an agent include instances when the amount the entity earns is predetermined, such as a fixed fee per transaction or a stated percentage of the amount billed. [FRS102.GL]

23.5 An entity is acting as a principal when it is exposed to the significant risks and rewards associated with the sale of goods or the rendering of services. Features indicating that an entity is acting as a principal include the entity having primary responsibility for providing the goods or services to the customer (e.g. by being responsible for the acceptability of the products or services); having inventory risk before or after the customer order, during shipping or on return; having latitude in establishing prices (either directly or indirectly); or bearing the customer's credit risk for the amount receivable from the customer. [FRS102.GL]

**Example 23.2**

Company C operates a website from which it sells Company D's products. Customers place orders and make payment through the website. C passes orders, after credit card authorisation, on to D and D then ships the product directly to the customer.

C does not take title to the product and has no risk of loss or other responsibility for the function or delivery of the product. D is responsible for all product returns, defects and disputed credit card charges. C sells the product for £175 and receives a commission of £25. If a credit card transaction is rejected, C does not receive the commission.

C recognises its fee of £25 as revenue as it does not take title to the product or take on any of the risks and rewards of ownership of the product; its credit risk is limited to its fee of £25.

23.6 When the transaction includes an element of financing via deferred payment terms, revenue is measured at the present value of future receipts. These receipts are discounted at the more clearly determinable of the rate for a similar instrument issued by an entity with a similar credit rating and the rate which discounts the future cash receipts to the current cash price of the goods or services. The difference between the fair value and the nominal value of future receipts is recognised as interest in accordance with paragraph 23.34 of this publication and Section 11 *Basic financial instruments*. [FRS102.23.5]

**Example 23.3**

Company E sells a product for £50,000, payable in cash on normal commercial terms. It introduces a new financing alternative for the same product with customers paying £53,000 one year from delivery. E determines that the interest rate that discounts the future cash receipts to the current cash price of the goods is 6%.

E recognises revenue of £50,000 (£53,000 discounted at 6% for one year) when the revenue recognition criteria are met. The remaining £3,000 is recognised as interest income over the period of the finance.

**Exchanges of goods or services**

23.7 Revenue is not recognised when the transaction is an exchange of goods or services that are of a similar nature and value or when the transaction lacks commercial substance. [FRS102.23.6]

23.8 Revenue is recognised when the transaction is an exchange of goods or services for dissimilar goods or services and the transaction has commercial substance. When the fair value of the goods or services received can be measured reliably, revenue is measured at that fair value adjusted for any cash or cash equivalents transferred to or from the entity. If this fair value cannot be measured reliably, then revenue is measured based on the fair value of the goods or services given up (again adjusted for cash or cash equivalents). If neither fair value can be measured reliably, the carrying amount of the assets given up (adjusted for cash or cash equivalents) is used to measure revenue. [FRS102.23.7]

**Identification of the revenue transaction**

23.9 If necessary to reflect the substance of the transaction, the revenue recognition criteria are applied separately to separately identifiable components of a single transaction, for example when the selling price of a product includes an identifiable amount for subsequent servicing. [FRS102.23.8]

23.10 Similarly, when two or more transactions are linked such that the commercial effect cannot be understood without considering all related transactions, the recognition criteria are applied to those transactions together. For example, the recognition criteria are applied to two transactions together when an entity sells and at the same time agrees to repurchase goods at a later date. [FRS102.23.8]

23.11 One approach to determining when separately identifiable components exist might be to consider whether the components have stand-alone value, such as considering whether the item is sold separately, if the customer could resell it or whether the customer derives value from that item independently from receiving other deliverables.

**Example 23.4A****Components without stand-alone value**

Company F agrees to provide research and development services to a customer for a specified period of time. The customer needs to use F's technology, which is not sold or licensed separately without the related research and development activities. The customer agrees to pay a non-refundable fee in addition to ongoing payments for research and development activities over the contract.

In our view, the payment of the fee does not generate stand-alone value; it is not sold separately, it cannot be resold by the customer and payment of the fee does not generate value for the customer independently from the ongoing research and development work.

F recognises the fee systematically over the period in which it provides the research services since that is the period over which it earns the fees.

**Example 23.4B****Components with stand-alone value**

Company G sells new cars and provides related servicing. As part of a summer promotion it sells cars with three years' free servicing. G ordinarily sells cars and servicing separately and so concludes that each is a separate component with stand-alone value. G recognises revenue from the sale of a car when the criteria of FRS 102.23.10 are met (see paragraph 23.17). In our experience this is generally when the car is delivered to the customer. It recognises servicing revenue when the servicing is carried out.

This form of 'unbundling' raises a related question – how should company G allocate revenue to the identified components?

23.12 FRS 102.23.3 requires that revenue is measured at the fair value of consideration received or receivable. FRS 102 contains guidance in respect of determining the fair value of customer loyalty awards (see paragraph 23.13) but does not provide guidance for other arrangements with multiple components. In our experience, appropriate allocation methods include relative fair values and residual fair values. We believe that a reverse residual method (in which a fair value is determined for the delivered component(s) and the residual amount is allocated to the undelivered component(s)) is generally unlikely to be appropriate as it may not result in an appropriate allocation of revenue to the delivered component.

**Example 23.5**

Continuing from Example 23.4B above, G determines that the fair value of the car is £30,000 and the fair value of the servicing is £2,500. For simplicity this example assumes there is no financing element to these transactions and so no discounting is required. Total consideration is £31,000.

	Relative fair value method £	Residual fair value method £
Revenue allocated to car	28,615 (31,000 × 30,000/(30,000+2,500))	28,600 (31,000 less the fair value of the undelivered component, 2,500)
Revenue allocated to servicing	2,385 (31,000 × 2,500/(30,000+2,500))	2,500 (the fair value of the undelivered component)
<b>Total consideration received</b>	<b>31,000</b>	<b>31,000</b>

23.13 Customer loyalty schemes, in which the customer is granted an award that it may redeem in the future for free or discounted goods or services, are accounted for as a separately identifiable component of the initial sales transaction. Common examples include retailer loyalty cards (award points are earned based on amounts spent with that retailer and can be redeemed against future shopping or other offers) and airline loyalty schemes (air miles are earned based on flights purchased and may be redeemed as part or full payment for future travel).

23.14 The fair value of the consideration received or receivable in respect of the initial sale is allocated between the loyalty award and the other components of the sale. The consideration apportioned to the loyalty award is measured by reference to the fair value of the award credits, i.e. the amount for which they could be sold separately. [FRS102.23.9] Whilst FRS 102 is not explicit, example 13 in the appendix to Section 23 makes clear that the fair value of the award credits takes into account the entity's expectations relating to redemption rates. Entities may also look to apply concepts within existing IFRS for more complex scenarios.

### Example 23.6

Company H sells beauty products. If customers buy a specific product for £25, they receive a voucher entitling them to a discount of £3 on their next purchase over a specific amount. H sells 100 of these £25 products and believes that 85% of customers will redeem their vouchers.

		Relative fair value method £
Revenue recognised on initial sales	(£2,500 less amounts deferred, measured at fair value of £255)	£2,245
Revenue deferred	(fair value of the loyalty award, measured at £3 x 100 x 85%)	£255
<b>Total consideration received</b>		<b>£2,500</b>

23.15 FRS 102 does not contain specific guidance detailing how to allocate deferred revenue to redeemed awards. Suitable approaches might include applying the principles within IFRIC 13, which would lead to reallocation of the deferred revenue balance to unredeemed awards, and the principles within old UK GAAP, which would lead to the recognition of changes in expectations relating to redemption rates being recognised within revenue.

23.16 Some arrangements may appear similar to loyalty schemes but subject to different accounting. When an entity gives discount vouchers or similar awards when no initial purchase is required (e.g. money-off coupons distributed by post), there is no requirement to recognise a liability (assuming no onerous contract exists). These vouchers represent an executory contract, under which neither party has yet performed.

### Sale of goods

23.17 Revenue from the sale of goods is recognised when:

Criteria	Example
<ul style="list-style-type: none"> <li>the significant risks and rewards of ownership of the goods have been transferred to the buyer;</li> </ul>	<p>A company produces and installs complex measuring equipment. Installation can only be carried out by the company due to its knowledge of the equipment, which cannot be used by the customer before the specialist installation work is complete and the company has calibrated the equipment to the customer's specifications. Revenue is not recognised when equipment is delivered to the customer as the significant risks and rewards of ownership have not passed until installation is complete.</p>

<ul style="list-style-type: none"> <li>the seller does not retain a level of continuing managerial involvement usually associated with ownership or effective control over the goods sold;</li> </ul>	<p>A company makes the majority of its sales in the winter. To incentivise customers to buy their goods at other times of the year, it offers discounts and pays for storage, shipping and insurance on 'off-peak' purchases. Since delivery is not delayed at the customer's request and the company pays the related costs, in our view the company retains managerial involvement and so should not recognise revenue for these transactions.</p>
<ul style="list-style-type: none"> <li>the amount of revenue and costs incurred or to be incurred in respect of the transaction can each be measured reliably; and</li> </ul>	<p>A company owns film rights, which it licences to third parties for onward distribution. Its consideration is 10% of revenues generated by the distribution of its films. The company determines that the range of possible outcomes and its historical experience of similar arrangements means that the amount of revenue cannot be measured reliably when the licence is issued (and the other criteria of Chapter 23 are met) and so no revenue is recognised. When revenue can be measured reliably, for example when the films are distributed or when the company has sufficient experience to make a reliable estimate, revenue is recognised.</p>
<ul style="list-style-type: none"> <li>it is probable that economic benefits will flow to the entity as a result of the transaction. [FRS102.23.10]</li> </ul>	<p>A company attempts to expand its overseas operations by seeking customers in country M. It recognises revenue ordinarily when goods are dispatched. Entities in country M are known for making late payments to suppliers and in some cases refusing to pay. Since the company has no experience in country M it determines that it is not probable that economic benefits will flow from its sales to country M and so does not recognise revenue when goods are dispatched.</p>

23.18 This assessment requires an examination of the circumstances of the transaction. In most cases the risks and rewards of ownership pass when legal title or possession transfers to the buyer. This would apply to most retail sales. Examples of situations when the seller retains the significant risks and rewards include:

- when the seller retains an obligation for unsatisfactory performance beyond that covered by a normal warranty arrangement;
- when the receipt of revenue is contingent on the buyer selling the goods to a third party;
- when goods are shipped subject to installation and that installation, which is a significant part of the contract, is not yet complete; and
- when the buyer has a right to return the goods, either for reasons specified in the sales contract or at the buyer's discretion, and the seller is not certain about the probability of return. [FRS102.23.11-12]

23.19 If only an insignificant risk of ownership is retained by the seller, revenue is recognised. This is the case when legal title is retained solely to protect the collectability of the amount due or when a refund is offered for faulty goods and the probability of such returns can be estimated reliably. [FRS102.23.13]

### Rendering of services

23.20 When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue is recognised using the percentage of completion method. For further information on the percentage of completion method, see paragraph 23.26 of this publication. Similar to the criteria for the recognition of revenue from the sale of goods, the outcome can be estimated reliably when the revenue, costs incurred and costs to complete the transaction can be measured reliably; it is probable that economic benefits will flow to the entity; and the stage of completion at the reporting date can be measured reliably. [FRS102.23.14]

23.21 When the services performed are an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis unless another revenue recognition method better represents the stage of completion. If one specific act within the contract is much more significant than any other act, recognition of revenue is postponed until that act has been performed. [FRS102.23.15] If the outcome of the transaction cannot be estimated reliably, revenue is recognised only to the extent that the expenses recognised are recoverable. [FRS102.23.16]

### Construction contracts

23.22 A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of design, technology and function or their ultimate purpose or use. [FRS102.GL]

23.23 Contract revenue and contract costs associated with a construction contract are recognised as revenue and expenses respectively by reference to the stage of completion of the contract when the outcome of the contract can be estimated reliably (the percentage of completion method). The outcome can be estimated reliably when the stage of completion, future costs and collectability of billings can be estimated reliably. [FRS102.23.17]

23.24 In some circumstances it may be necessary to treat identifiable components of a single contract separately or to consider a group of contracts together in order to reflect the substance of a contract or a group of contracts. [FRS102.23.18] Some construction contracts cover the construction of a number of assets. The construction of each asset is treated as a separate contract when separate plans subject to separate negotiation are submitted for each asset; the contractor and customer may accept or reject parts of the contract relating to each asset; and the costs and revenues of each asset can be separately identified. [FRS102.23.19]

23.25 A group of contracts is treated as a single construction contract, whether with a single customer or with several customers, when the contracts are negotiated as a single arrangement that is in effect a single project with an overall profit margin and the contracts are performed concurrently or in a continuous sequence. [FRS102.23.20]

#### Example 23.7

Company N signs separate contracts concurrently, to construct two office buildings in sequence on the same site for a single customer. The first building will be completed before the second building phase commences. The price for the two contracts is negotiated as a single package and the contracts are performed in a continuous sequence. N determines that the two contracts are so closely interrelated that they represent a single project with an overall profit margin and applies construction contract accounting to that single arrangement.

### Percentage of completion method

23.26 Revenue from rendering services and from construction contracts is recognised using the stage or percentage of completion method. The estimates of revenue and costs are reviewed and, when necessary, revised as the arrangement progresses. [FRS102.23.21]

23.27 Stage of completion of a transaction or contract is determined using the method that measures the work performed most reliably. Progress payments and advances received from customers are often not representative of the work performed. Techniques to measure the stage of completion include:

- (a) the costs incurred for work performed to date as a proportion of the estimated total costs. Costs incurred for work performed to date do not include costs relating to future activity, such as for materials or prepayments;
- (b) surveys of work completed; and
- (c) completion of a physical proportion of the contract work or the completion of a proportion of the service contract. [FRS102.23.22]

23.28 Prepayments or other costs that relate to future activity, such as materials, are recognised as an asset when it is probable that those costs will be recovered. [FRS102.23.23] Costs whose recovery is not probable are recognised immediately as an expense. [FRS102.23.24]

### Application of the percentage of completion method

23.29 An entity uses its judgement to determine which of the above methods is the most appropriate for its construction contracts. Different methods can lead to different measures of the percentage of completion, as illustrated in example 23.8 below.

#### Example 23.8

Company P enters into a construction contract to build a road for £25m. It will receive stage payments over the life of the contract and estimates its contract costs at £20m.

At the first reporting date P has incurred costs of £12m. This includes £2m for the purchase of materials not yet used. An external survey estimates that P has completed 45% of the project. Stage payments totalling £7m have been invoiced and paid by the customer.

##### *P measures percentage of completion using costs incurred*

The project is 50% complete at the reporting date as costs incurred, excluding those related to future activities, are £10m and total costs are £20m. P would recognise revenue of £12.5m (50% x £25m) and costs of £10m. Revenue recognised in excess of amounts billed (£12.5m less £7m invoiced to date) is recognised as accrued income. £2m, representing costs incurred relating to future activities, is recognised as work in progress within inventories.

##### *P measures percentage of completion using a survey of work performed*

The project is 45% complete at the reporting date based on the survey. P would recognise revenue of £11.25m (45% x £25m) and costs of £10m. Revenue recognised in excess of amounts billed (£11.25m less £7m invoiced to date) is recognised as accrued income. £2m, representing costs incurred relating to future activities, is recognised as work in progress within inventories.

Management should use judgement to decide which method is the most appropriate.

23.30 If the outcome of a construction contract cannot be estimated reliably:

- (a) revenue is recognised only to the extent of contract costs incurred, when it is probable that those amounts will be recoverable; and
- (b) contract costs are recognised as an expense in the period in which they are incurred. [FRS102.23.25]

23.31 Expected losses (when it becomes probable that contract costs will exceed contract revenue) are recognised as an expense in profit or loss immediately. A corresponding onerous contract provision is recognised. [FRS102.23.26]

#### Example 23.9

Company Q enters into a construction contract to build a ship. It uses the cost incurred method to measure percentage of completion.

Contract revenue is £15m and Q's initial estimate of contract costs is £13m. Due to production difficulties this estimate is reviewed to £18m and the expected loss on the contract is £3m.

At the reporting date, contract costs incurred are £12m, none of which relate to future activity. The contract is 67% complete.

Q recognises contract revenue of £10m (67% x £15m) and contract costs of £12m. This would result in a contract loss of £2m. However, FRS 102 requires an expected loss to be recognised immediately. The expected loss (the excess of expected contract costs over contract revenue) is £3m and so an additional onerous contract provision of £1m is recognised.

23.32 Chapter 21 provides additional guidance on the presentation of provisions. When the collectability of an amount already recognised as revenue is no longer probable, this is recognised as an expense. Contract revenue is not adjusted. [FRS102.23.27]



### Interest, royalties and dividends

23.33 Revenue arising from the use of an entity's assets by others, yielding interest, royalties or dividends for the entity, is recognised when it is probable that economic benefits associated with the transaction will flow to the entity and the amount can be measured reliably. [FRS102.23.28]

23.34 Interest income is recognised using the effective interest method as described in paragraph 11.68 of this publication. [FRS102.23.29]

23.35 Royalties are recognised on an accruals basis in accordance with the substance of the relevant agreement. [FRS102.23.29] The requirement for reliable measurement may mean that, in many cases (for example when a royalty is payable based on a percentage of the revenue generated by the licensee), it is not possible to recognise royalty income until amounts are received from the licensee.

23.36 Dividends are recognised when the entity's right, as shareholder, to receive payment is established. [FRS102.23.29] Determining when a shareholder's right to receive payment has been established will include gaining an understanding of the legal framework. For example, a UK company can pay an interim or a final dividend. An interim dividend is declared by the directors but is never a liability of the company – it can be varied or withdrawn at any time by the directors. As a result an interim dividend 'receivable' is not recognised as income/a debtor because the shareholder has no right to receive payment until the directors choose to make payment. A final dividend is one proposed by the directors but approved by shareholders at a general meeting. Once approved by those shareholders the dividend is recognised as a liability by the 'paying' company and so, assuming the recipient believes it is probable that it will receive these economic benefits (which would ordinarily be the case), the recipient recognises income and a debtor.

### Further guidance

23.37 The appendix to Section 23 *Examples of revenue recognition under the principles in Section 23* provides further examples on the application of these requirements.

### Transition

23.38 No exemption is available from retrospective application of the requirements of this section of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.



## vs previous UK GAAP

Applicable standards: SSAP 9, FRS 5, UITF 26, UITF 34, UITF 36, UITF 40

pUK23.1 When a contractual arrangement covers the provision of a number of different goods or services, FRS 5 provides more detailed guidance than FRS 102 for determining whether such ‘components’ are accounted for together or separately.

pUK23.2 FRS 5 includes specific guidance on various other revenue recognition matters, including determining whether an entity is principal or agent. FRS 5 requires that subsequent changes in estimates of a liability for outstanding loyalty awards in a customer loyalty programme (known as voucher accounting in FRS 5) are recognised in revenue.

pUK23.3 The scope of SSAP 9 may differ from that of FRS 102. SSAP 9 deals with long-term contracts, which are contracts for either the construction of an asset or the provision of services when the contract activity falls into different accounting periods such that not recognising turnover and attributable profit on contracts in progress would distort the true and fair view. Some arrangements meeting the definition of a long-term contract in SSAP 9 may not meet the definition of a construction contract within FRS 102.

## vs EU-IFRS

Applicable standards: IAS 11, IAS 18, SIC-31, IFRIC 13, IFRIC 15

IFRS23.1 IAS 18 has a similar scope to FRS 102. However, revenue arising from the extraction of mineral ores and changes in the value of current assets are excluded from the scope of IAS 18.

IFRS23.2 IFRIC 13 provides additional guidance on customer loyalty programmes. This includes the required accounting when a third party issues awards and the recognition of onerous awards.

IFRS23.3 IFRIC 15 provides more detailed guidance on the accounting for the construction of real estate. These arrangements are accounted for under either IAS 11 or IAS 18, primarily depending on when control of the constructed asset passes to the customer. IFRIC 15 introduces the concept of continuous transfer. The continuous transfer method is not included in FRS 102.

# 24 Government grants

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## OVERVIEW OF REQUIREMENTS

- Deals with all government grants.
  - Normal trading transactions and assistance that cannot reasonably have a value placed on them are not government grants. Government assistance provided through adjustment to income taxes is accounted for as part of those taxes (see Section 29 *Income tax*).
  - The choice of performance or accrual model is made on a class-by-class basis.
  - In the performance model the grant is recognised when its performance conditions are met.
  - In the accrual model revenue grants are recognised in income over the same period as the related costs; asset-related grants are recognised in income over the life of the asset.
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## FRS 102

### Section 24

#### Scope

24.1 This section deals with all grants by government. Government grants are transfers of resources to an entity by a local, national or international government entity in return for compliance with certain past or future conditions related to the operating activities of the entity receiving the grant. [FRS102.24.1, FRS102.GL]

24.2 This section does not cover government assistance that cannot be valued (for example infrastructure that is also available to others) or be differentiated from the entity's normal trading activity (for example arrangements to supply government entities with goods or services at market rates). Neither does it cover benefits that are available through the determination of taxable profit or calculated by reference to the entity's tax liability, such as income tax holidays, investment tax credits, capital allowances and reduced income tax rates (see Section 29 *Income tax*). Non-exchange transactions (i.e. donations of cash, goods or services) are covered in Chapter 34I of this publication. [FRS102.24.3]

#### Recognition and measurement

24.3 Grants are recognised only when there is reasonable assurance that the conditions attached to the grant will be met and the grant will be received. Grants are measured at the fair value of the asset receivable. A liability is recognised when a grant becomes repayable and meets the definition of a liability. [FRS102.24.3A,5,5A]

24.4 Grants are recognised using either the performance model or the accrual model. The same policy is applied consistently to a class of grant. [FRS102.24.4]

#### Performance model

24.5 A grant with no future performance conditions is recognised in income when it is received or receivable. [FRS102.24.5B(a)]

24.6 A grant that imposes future performance conditions on the recipient is recognised in income when these conditions are met. [FRS102.24.5B(b)]

24.7 Grants received before the recognition criteria are met are recognised as a liability. [FRS102.24.5B(c)]

#### Example 24.1A

##### Grant with no future performance conditions

Entity A receives a government grant of £1m as a contribution towards its past product development. Receipt of the funds is not conditional on achieving future development milestones i.e. there are no performance conditions attached to the grant.

A recognises the grant as income when the funds are received or receivable.

##### Grant with future performance conditions

Entity B receives a government grant of £5m on 1 January 20X1. The award is conditional on the completion of construction of a new manufacturing facility within a designated area before 31 December 20X3.

On 1 January 20X1 the funds have been received but the performance condition (completion of the facility in the designated area before 31 December 20X3) has not been met. B recognises a liability of £5m.

Construction is completed on 30 September 20X3. At this point B derecognises the liability (having met all of the performance conditions related to the government grant) and recognises income of £5m.

#### Accrual model

24.8 Under the accrual model a grant is classified as relating either to revenue or to assets. [FRS102.24.5C]

24.9 Revenue grants are recognised in income on a systematic basis over the same period as the related costs. [FRS102.24.5D] When those costs have already been incurred, the grant is recognised in income when it is receivable. [FRS102.24.5E]

24.10 Asset grants are recognised in income on a systematic basis over the life of the related asset. [FRS102.24.5F]  
Grants relating to assets are recognised as deferred income. They are not deducted from the carrying value of the asset. [FRS102.24.5G]

### **Example 24.1B**

#### **Accrual model**

Entity A's award in Example 24.1A above is a grant relating to revenue under the accrual model. Since it compensates A for past expenses, it is recognised as income immediately.

Entity B's award is a grant relating to an asset under the accrual model. It is recognised in income on a systematic basis over the expected life of the related asset.

### **Transition**

24.11 No exemption is available from retrospective application of the requirements of this section of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

## vs previous UK GAAP

### Applicable standards: SSAP 4

pUK24.1 Government grants are not recognised in profit or loss until the conditions attached to the grant are met and there is reasonable assurance that the grant will be received. While the FRS 102 performance model contains a similar restriction, the accrual model has only the general recognition restriction of there being reasonable assurance that the conditions will be met.

pUK24.2 SSAP 4 allows non-Companies Act entities to offset grants against the cost of the related asset.

## vs EU-IFRS

### Applicable standards: IAS 20, IAS 41, SIC-10

IFRS24.1 IAS 20 requires the recognition of government grants in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate. The accrual model in FRS 102 follows this approach, whereas the performance model requires immediate recognition of grant income when all performance conditions are met (regardless of when the related costs are incurred).

IFRS24.2 IAS 41 deals with grants relating to biological assets recognised at fair value less costs to sell, including those requiring the entity not to engage in specified agricultural activity. These grants are recognised only when they become receivable. This may be in a different period from that in which the related costs are incurred. These grants are not deducted against the carrying amount of the biological asset.

IFRS24.3 IAS 20 allows grants of non-monetary assets to be recognised at the fair value of the non-monetary assets or at a nominal amount. Non-monetary grants are within the scope of Section 24, and are accounted for at fair value.

IFRS24.4 IAS 20 allows grants relating to assets to be presented as deferred income or as a deduction from the carrying amount of the asset.

IFRS24.5 IAS 20 includes additional guidance on accounting for forgivable loans and below-market-rate loans from government.

# 25 Borrowing costs

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## OVERVIEW OF REQUIREMENTS

- Borrowing costs may either be capitalised or expensed in profit or loss in the period in which they are incurred. The policy choice is applied consistently to a class of qualifying assets.
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## FRS 102

### Section 25

#### Accounting policy choice

25.1 Borrowing costs are interest and other costs that are incurred in connection with the borrowing of funds.

25.2 For borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets FRS 102 provides an accounting policy choice between capitalising the borrowing costs into the cost of the asset, or expensing them in profit or loss as incurred.

25.3 The adopted policy must be applied consistently to a class of qualifying assets. [FRS102.25.2] FRS 102 defines a class of assets as 'a grouping of assets of a similar nature and use in an entity's operations'. [FRS102.GL] This leaves scope for judgement in determining how many classes of assets an entity has. However, we would expect the property, plant and equipment classes for the purpose of Section 25 to be consistent with those disclosed under Section 17 *Property, plant and equipment*.

25.4 A change from expensing borrowing costs in profit or loss to capitalising or vice versa is a change in accounting policy. Refer to Section 10 *Accounting policies, estimates and errors* for general guidance regarding accounting policy changes.

#### Qualifying assets

25.5 A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Qualifying assets may include inventories, manufacturing plants, power generation facilities, intangible assets and investment properties. Financial assets (including investments in subsidiaries, associates and joint ventures) are not qualifying assets. Further, assets that are ready for their intended use or sale when acquired are not qualifying assets. [FRS102.GL]

25.6 Certain types of inventories may take a long time to get ready for intended use or sale. Judgement will be required in determining whether a 'substantial period of time is taken', as FRS 102 does not provide any further clarification in this area. We anticipate 'a substantial period of time' to be generally interpreted as a period well in excess of six months. Whisky or property are examples of inventories that typically take a long time to produce and that may therefore meet the definition of qualifying assets.

#### Borrowing costs eligible for capitalisation

25.7 Section 25 defines borrowing costs as interest and other costs that an entity incurs in connection with the borrowing of funds. Borrowing costs include:

- Interest expense calculated using the effective interest method as described in Section 11 *Basic financial instruments*. This includes the amortisation of any discount or premium that forms part of the effective interest rate. In our view, transaction costs that are an integral part of the effective interest rate are also eligible for capitalisation.
- Finance charges in respect of finance leases recognised in accordance with Section 20 *Leases*.
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. [FRS102.25.1]

25.8 Borrowing costs eligible for capitalisation are those costs that would have been avoided if the qualifying asset had not been acquired, constructed or produced. [FRS102.25.2A] In addition to interest on specific borrowings made to obtain the qualifying asset, this includes the cost of borrowings that could have been repaid if expenditure on the qualifying asset had not been incurred.

25.9 In our view, gains and losses arising on the early termination or repayment of borrowings do not generally meet the definition of borrowing costs when the gains and losses relate to a change in an entity's choice of financing arrangements, rather than being directly attributable to the acquisition, construction or production of a qualifying asset.

25.10 Borrowing costs are interest and other costs that are incurred in connection with the borrowing of funds. We would interpret the reference to 'funds' in the definition of borrowing costs as including not just loans and other interest-bearing borrowings, but also other instruments classified as financial liabilities, e.g. preference shares with mandatory dividends.

25.11 Further, in our view, the interest component of financial liabilities that fail the criteria for basic debt classification (see paragraph 11.13 of this publication) is also eligible for capitalisation as a borrowing cost. Whilst these financial liabilities must be measured at fair value through profit or loss, it is nevertheless possible to calculate an effective interest rate and capitalise

borrowing costs on that basis. In our view, the fair value changes of financial liabilities should not be capitalised as borrowing costs.

25.12 In our view, dividends incurred in connection with equity instruments are not borrowing costs as they are not ordinarily expensed in profit or loss.

### Specific and general borrowings

25.13 The amount of borrowing costs eligible for capitalisation is determined as follows:

- If the funds are borrowed specifically to fund the qualifying asset: actual borrowing costs incurred less any investment income on any temporary investment of the borrowing. [FRS102.25.2B]
- If the funds used to obtain the asset form part of the entity's general borrowings: a capitalisation rate is applied to the expenditure on the qualifying asset. [FRS102.25.2C]

25.14 The capitalisation rate for general borrowings is the weighted average interest rate for those borrowings outstanding in the period, excluding any borrowings specific to any qualifying assets. [FRS102.25.2C]

25.15 The expenditure on which interest is capitalised is the average carrying amount of the qualifying asset during the period, including previously capitalised borrowing costs. The amount of borrowing costs capitalised in a period cannot exceed the actual borrowing costs incurred in that period. [FRS102.25.2C]

#### Example 25.1

Company X incurs expenditure of £10 million on the construction of a new factory, which is funded out of X's existing general borrowings. X has the following general borrowings outstanding during the period:

	Average balance outstanding (£'000)	Interest expense (£'000)
10-year fixed rate loan	14,000	840
5-year floating rate loan	6,000	450
Bank overdraft	2,000	200
<b>Total</b>	<b>22,000</b>	<b>1,490</b>

The capitalisation rate to be applied is the weighted average of rates applicable to X's general borrowings that are outstanding during the period and is determined as follows:

$$\frac{\text{Total interest expense during period}}{\text{Average amount of borrowings outstanding}} = \frac{1,490}{22,000} = 6.77\%$$

Let's assume that the average carrying amount, including borrowing costs previously capitalised, of the factory during the period is £5 million. Therefore, the amount of borrowing costs eligible for capitalisation is:

$$£5,000,000 \times 6.77\% = £338,500.$$

### Foreign exchange differences

25.16 FRS 102 states that borrowing costs include exchange differences from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. [FRS102.25.1(c)] However, no further guidance is provided by FRS 102 on the meaning of 'to the extent that they are regarded as an adjustment to interest costs'.

25.17 Theoretically, a sterling functional currency entity taking out a euro loan at a euro interest rate and exchanging the cash to and from sterling should, from a value perspective, be similar to taking out a sterling loan at a sterling interest rate, as exchange rate movements are expected to compensate for any interest rate differential.

25.18 For example, assume a UK bank offers a one-year interest rate on sterling loans of 3.5 percent, and a euro bank offers an interest rate of 2.5 percent on one-year euro loans. Although sterling functional currency companies could borrow in euros (to take advantage of the lower interest rates) and convert the loan proceeds into sterling, they face currency risk as they will



need to settle the loan in euros at maturity. If they wish to hedge this currency risk in the forward market by buying euros one year forward, the cost of such hedging would be approximately equal to the 1 percent difference in rates between sterling and euro. The 1 percent could effectively be regarded as an adjustment to interest.

25.19 Unless actual exchange rates move in a significantly different manner to forward exchange rates, parity should be maintained.

25.20 Based on the above theory of interest rate parity, one interpretation of FRS 102.25.1(c) might be that entities can capitalise either:

- the actual foreign currency interest incurred (at the contractual interest rate) translated into the entity's functional currency at the average exchange rate for the period, i.e. no exchange differences included in borrowing costs; or
- interest at the hypothetical interest rate that would have been incurred on a borrowing with identical terms in the functional currency of the entity. However, in our view, total borrowing costs capitalised should then be capped at the sum of the actual interest expense incurred and the actual foreign exchange differences experienced on the loan.

25.21 Foreign exchange differences not capitalised as part of borrowing costs are recognised in profit or loss as incurred.

25.22 In our view, the inclusion of exchange differences as part of borrowing costs is an accounting policy choice that should be applied consistently to each class of qualifying assets.

### Example 25.2

Company A has a £ sterling functional currency and borrowed \$1,000,000 on 1 January 20X5 for two years at 3% per annum to finance the construction of a new factory. When A took out the loan, sterling was expected to weaken against the dollar and the two-year sterling interest rate was 5%. Actual exchange rates were:

	Exchange rate (£:\$)
1 January 20X5	1.6
31 December 20X5	1.56
Average for the year	1.58

Actual interest incurred (translated into A's functional currency at the average exchange rate for the year) was £18,987 (\$30,000 × 1/1.58).

The hypothetical interest that would have been incurred on a borrowing with identical terms in A's functional currency is £31,250, i.e., £625,000 at 5%.

The total foreign exchange loss arising on the retranslation of the foreign currency borrowings at the closing exchange rate is:

$$\$1,000,000/1.56 - £625,000 = £16,025.$$

When added to the actual interest incurred on the dollar loan, this gives a total cost of £35,012.

If A uses the interpretation of FRS 102.25.1(c) set out in paragraph 25.20 above, then it can, depending on its accounting policy choice, either:

- capitalise borrowing costs of £18,987 (actual interest incurred) and expense foreign exchange losses of £16,025; or
- capitalise borrowing costs of £31,250 (hypothetical interest on identical £ borrowings) and expense foreign exchange losses of £3,762.

### Tax

25.23 In our view, the amount of borrowing costs to be capitalised should be calculated on a pre-tax basis. Borrowing costs that are capitalised may give rise to deferred tax.

### Period of capitalisation

25.24 Capitalisation of borrowing costs commences when an entity first incurs expenditure on the asset and borrowing costs. In our view, if finance is raised in advance of a major project, borrowing costs cannot be capitalised until work on the project has started.

25.25 Capitalisation ceases when substantially all the activities to prepare the asset for use or sale are complete, even if the asset has not yet been brought into use. For example, an entity has built a house that it intends to lease out. The development work is complete, but the property requires minor decoration before it is leased out. In our view, capitalisation should cease when the development work is complete.

25.26 Capitalisation is suspended when active development has paused for an extended period. [FRS102.25.2D] There is no guidance in FRS 102 over the length of time that is considered an extended period. For example, in some cases it may be appropriate to suspend capitalisation of borrowing costs when an entity is awaiting delivery of parts.

### Transition

25.27 If an entity expensed borrowing costs under previous GAAP and chooses to adopt a policy of capitalisation under FRS 102, it may use the date of transition to FRS 102 as the date on which capitalisation of borrowing costs on qualifying assets commences. [FRS102.35.10(o)] See also paragraph 35.38 of this publication.

25.28 Conversely, if an entity capitalised borrowing costs under previous GAAP and chooses to adopt a policy of expensing such costs under FRS 102, then no transitional relief is available and the change in accounting policy is applied fully retrospectively.

25.29 Equally, if an entity decides to switch from expensing borrowing costs to a policy of capitalisation after the date of transition to FRS 102, then there does not appear to be any relief from full retrospective application of the change in accounting policy.

## vs previous UK GAAP

### Applicable standards: FRS 15

pUK25.1 Previous UK GAAP addresses capitalisation of borrowing costs only for tangible fixed assets. If the entity adopts an accounting policy of capitalising borrowing costs, then directly attributable finance costs are included in the asset's cost. The scope of FRS 102 is wider, including, for example, inventories that take a substantial period of time to get ready for sale.

pUK25.2 Under previous UK GAAP, if an entity adopts a policy of capitalisation of borrowing costs, this is applied consistently to all tangible fixed assets. Under FRS 102, the adopted policy is instead applied consistently to a class of qualifying assets.

## vs EU-IFRS

### Applicable standards: IAS 23

IFRS25.1 Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are required to be capitalised as part of the cost of that asset. There is no option to expense such costs.

# 26 Share-based payment

## OVERVIEW OF REQUIREMENTS

- In an equity-settled share-based payment the entity either receives goods or services as consideration for its own equity instruments, or receives goods or services but has no obligation to settle the share-based payment transaction.
- In a cash-settled share-based payment a liability, based on the price or value of equity instruments of the entity or another group entity, is incurred in exchange for goods or services received.
- When goods are obtained or services received there is a corresponding increase in equity, for equity-settled share-based payments, or a liability, for cash-settled share-based payments.
- If a share-based payment to an employee vests immediately there is an immediate increase in equity or liabilities. If the share-based payment does not vest until the employee has completed a specified period of service there is a corresponding increase in equity or liabilities as those services are received.
- Share-based payments may be subject to the achievement of vesting conditions. These are usually related to service or performance.
- Equity-settled share-based payments are measured at the fair value of the goods or services received when this can be estimated reliably.
- Market and non-vesting conditions are reflected in the initial measurement of fair value of the equity-settled share-based payment. There is no subsequent adjustment if these conditions are not satisfied.
- An estimate is made for the number of equity instruments for which service and non-market performance conditions are expected to be satisfied. This estimate is trued-up to the number ultimately satisfied.
- The fair value of a modification to the vesting conditions that is beneficial to the employee is accounted for over the modified vesting period; other modifications are ignored.
- Cancellations or settlement of equity-settled share-based payments are treated as an acceleration of vesting; any remaining charge is recognised immediately.
- Cash-settled share-based payment transactions are measured at the fair value of the liability incurred. This liability is remeasured until the award is settled. Movements are recognised in profit or loss.
- A share-based payment transaction when the entity has a choice of settlement is treated as an equity-settled share-based payment unless the choice of settlement in equity instruments has no commercial substance or the entity has a past practice or stated policy of settling in cash. When the counterparty has the choice of settlement, a share-based payment transaction is treated as a cash-settled share-based payment unless there is no commercial substance to the cash settlement offer.
- Members of a group share-based payment plan can recognise and measure their share-based payment expense based on a reasonable allocation of the share-based payment expense of the group.

## FRS 102

### Section 26

26.1 This section covers both equity-settled and cash-settled share-based payment transactions and transactions when either party has a choice of either equity or cash settlement. [FRS102.26.1]

26.2 In an equity-settled share-based payment transaction, goods or services are received as consideration for equity instruments (e.g. shares or share options) or are received but the entity has no obligation to settle the share-based payment transaction. [FRS102.26.1(a)]

26.3 In a cash-settled share-based payment transaction, goods and services are acquired by incurring a liability that is based on the price or value of equity instruments of the entity or of another group entity. [FRS102.26.1(b)] Cash-settled share-based payments include share appreciation rights (an entitlement to a future cash payment based on the increase in the entity's or another group entity's share price over a specified period of time) and arrangements in which employees are granted a right to equity instruments that are redeemable, either mandatorily (e.g. upon cessation of employment) or at the employee's option. [FRS102.26.2]

26.4 A share-based payment transaction may be settled by another entity within the group, or a shareholder of any group entity, on behalf of the entity receiving the goods or services. The requirements of this section apply to such transactions unless the transaction is clearly unrelated to the goods or services received. [FRS102.26.1A]

#### Example 26.1

Company A awards 10 shares to employees of A provided they remain in service for the next 12 months. This is an equity-settled share-based payment – the employees will receive 10 shares if they provide the required period of service to A.

Company B awards employees a cash bonus equal to B's share price growth, provided they remain in service over the next 12 months. This is a cash-settled share-based payment – B has an obligation to pay cash to employees meeting the service requirement and the amount payable is based on the change in the share price. This award is also known as a share appreciation right.

Company C awards a cash bonus of £500 to employees, payable in one year to those who remain in service, if C's share price exceeds £10 per share during the next 12 months. This is not a share-based payment. Whilst an obligation exists if the share-price related target is met and the employee delivers services to C, the amount of the payment is not based on the share price of C. The award is likely to be within the scope of Section 28 *Employee benefits*.

#### Recognition

26.5 The goods or services acquired in a share-based payment transaction are recognised when the entity obtains the goods or as the services are received. A corresponding increase in equity for an equity-settled share-based payment transaction, or a liability for a cash-settled share-based payment transaction, is recognised. [FRS102.26.3] The amounts recognised in a share-based payment transaction are recognised as assets when they meet the recognition requirements of another section of FRS 102, such as Section 13 *Inventories* or Section 18 *Intangible assets other than goodwill*, or are expensed. [FRS102.26.4] However, remeasurement of a cash-settled share-based payment liability is recognised in profit or loss. [FRS102.26.14]

26.6 When an employee is unconditionally entitled to a share-based payment without completing a period of service, the share-based payment vests immediately. The services received from the employee are recognised in full on the grant date and equity or liabilities are increased accordingly. [FRS102.26.5]

26.7 If the share-based payment does not vest until a required period of service has been completed, it is presumed that the services to be received in consideration for the payment will be received in the future over the vesting period. [FRS102.26.6]

#### Measurement of equity-settled share-based payment transactions

26.8 Equity-settled share-based payments are measured at the fair value of the goods or services received. If this cannot be estimated reliably, the fair value of the equity instruments granted is used instead. In transactions with employees the fair value of the services received is measured by reference to the fair value of the equity instruments granted. [FRS102.26.7]

26.9 For transactions with employees fair value is measured at grant date. For transactions with other parties fair value is measured when services are rendered or goods received. [FRS102.26.8] The glossary within FRS 102 describes grant date as the date at which 'the entity and counterparty have a shared understanding of the terms and conditions of the arrangement'. [FRS102.GL]

26.10 In some cases receipt of the share-based payment is conditional on certain vesting conditions being met. Vesting conditions are usually related to service or performance.

i. Service conditions	ii. Performance conditions	
	Market conditions	Non-market conditions
A requirement to remain an employee for a stated period	Conditions that relate to the share price of the entity e.g. Total Shareholder Return (TSR) growth	Conditions not related to the share price e.g. profit targets or EPS growth

26.11 There may also be non-vesting conditions (e.g. the employee making regular contributions to a plan or the movement of a commodity index). [FRS102.26.9, FRS102.GL]

26.12 Vesting conditions relating to service or non-market performance are considered when estimating how many equity instruments will vest. That estimate is subsequently revised if conditions and expectations change. On the vesting date the estimate is revised to reflect the actual number of equity instruments that vested. Market vesting conditions and non-vesting conditions are taken into account only when estimating the fair value of the equity instruments awarded. These estimates are not subsequently adjusted, regardless of the outcome of the market or non-vesting condition. [FRS102.26.9]

#### Example 26.2 Award including service and market condition

Company F awards 10 shares to employee E, provided E remains in service for the 3 years to 31 December 2015 and the share price increases by at least £20. E is receiving an equity-settled share-based payment with a 3-year vesting period. The award has both a service condition (three year service requirement) and a market condition (the award vests only if the share price increases by at least £20).

The fair value of each share award, measured at grant date, is £60. The likelihood of achieving a market condition (in this case a share price target) is taken into account by the valuation model when calculating this value.

F expects E to complete the required service, and they do. An expense of £200 is recognised ( $10 \times £60 \times 1/3$ ) in each of the 3 years. An equity-settled share-based payment expense is not adjusted for actual achievement of market conditions. The equity-settled expense is recognised even if the market condition is not ultimately achieved and so the award does not vest. The likelihood of achieving the market condition is included, based on conditions existing at the grant date, within the fair value.

#### Example 26.3 Award including service and non-market condition

Company G awards 10 shares to employee X, provided they remain in service for the 3 years to 31 December 2015 and the profit for each of those 3 years is above £10m. X receives an equity-settled share-based payment with a 3-year vesting period. The award has both a service condition and a non-market condition.

The fair value of the award is determined to be £75 per share. This fair value does not take into account the likelihood of achieving the service condition or the non-market condition. Expected achievement of the service and non-market conditions affects the number of awards expected to vest and so changes the total share-based payment expense recognised in each period.

At the end of the first year G expects the employee to meet the 3-year service requirement and to reach its profit target in each of the 3 years. As a result G recognises an expense of £250 ( $10 \times £75 \times 1/3$ ).

Changes in expectations relating to service or non-market conditions can lead to the recognition of different amounts in different periods and the reversal of previously recognised share-based payment expenses.

In the year ended 31 December 2016 G continues to expect the employee to meet the 3-year service requirement but no longer believes the profit target will be met in year 3. As a result the cumulative expense recognised at the end of 31 December 2016 is nil and so G recognises a gain of £250 (reversing the expense recognised in the previous period).

If ultimately the service and non-market conditions are met in year 3 then £750 will be expensed. If the conditions are not met then no additional expense will be recognised.

## Graded vesting

26.13 Some awards vest in tranches throughout the vesting period. These characteristics are commonly referred to as graded vesting. The issue is whether these awards are treated as concurrent awards or consecutive awards. EU-IFRS requires these awards to be treated as concurrent awards; FRS 102 does not contain explicit guidance on this issue.

### Example 26.4 Graded vesting

Company G offers an equity-settled share-based payment award to an employee. The employee receives 60 shares in total, but those shares vest in equal instalments over 3 years. That is, the employee receives 20 shares at the end of year 1, 20 shares at the end of year 2 and 20 shares at the end of year 3. For simplicity assume the employee is expected to, and ultimately does, meet the service condition. If the requirements of EU-IFRS are applied to this arrangement it is considered to be three concurrent awards, i.e., a grant of 20 shares with a 1-year vesting period, 20 shares with a 2-year vesting period and 20 shares with a 3-year vesting period.

This leads to a 'front loading' of the expense as illustrated below (for simplicity each tranche has the same fair value of £4.50).

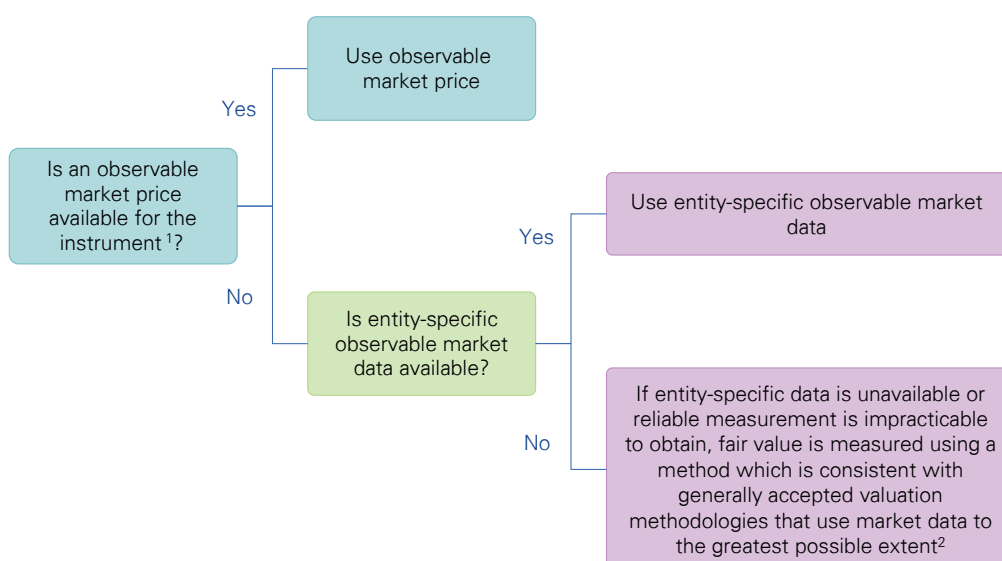
	Year 1	Year 2	Year 3	Total
Tranche 1 (1-year vesting period)	90	0	0	90
Tranche 2 (2-year vesting period)	45	45	0	90
Tranche 3 (3-year vesting period)	30	30	30	90
	<b>165</b>	<b>75</b>	<b>30</b>	<b>270</b>

The alternative approach would be to consider the arrangement to be three consecutive 1-year share-based payment arrangements each with a fair value of £90; an expense of £90 is recognised in each period.

26.14 We believe that an entity should consider the facts and circumstances of each award when determining which approach could be applied. Factors may include whether new employees are able to join the scheme during the three year period and be eligible for the share-based payment arrangement. This would indicate the arrangement is, in substance, a number of one-year share-based payments.

## Fair value of shares, share options and equity-settled share appreciation rights

26.15 A three-tier measurement hierarchy is used to measure the fair value of shares, share options and equity-settled share appreciation rights: [FRS102.26.10, FRS102.26.11]



### Notes:

1. For example a recent sale transaction or recent independent valuation of the entity.
2. This may often be the case particularly for options. The directors use their judgement to apply appropriate valuation methodology. For options and share appreciation rights, an option pricing model is normally used. Inputs include weighted average share price, exercise price, option life, expected dividends, expected volatility and the risk-free interest rate. Estimates of expected volatility are determined in a manner consistent with the technique used to determine the share price.

### Modifications to the terms and conditions on which equity instruments were granted

26.16 Modifications change the terms of the share-based payment arrangement. If a modification is beneficial to the recipient, for example, by changing the service or market conditions so that they are easier to meet, the incremental fair value is included in the amount recognised for services received. The incremental fair value is the difference between the modified and unmodified arrangements, both measured at the modification date. If the modification occurs during the vesting period, the incremental fair value is spread over the period from the modification date to the modified vesting date. The original fair value continues to be recognised on the same basis as before modification. [FRS102.26.12(a)]

26.17 FRS 102 does not give explicit guidance on accounting for modifications that are beneficial to the recipient but do not increase the fair value of the award. An example of such a modification would be the reduction in an EPS target. The entity recognises the remaining fair value using the revised vesting expectations.

26.18 Modifications that reduce the fair value or are otherwise not beneficial to the employee are ignored. The entity continues to account for the services received under the original award as if the modification had not occurred. [FRS102.26.12(b)]

#### Example 26.5 Beneficial modification of market condition

On 1 January 20X1 Company G awarded 1,000 shares to its Chairman. The award was subject to a 2-year service condition and achievement of a share price target of £15 at 31 December 20X2. The fair value of the award as measured at grant date, which took into account the likelihood of achieving the share price target, was £5. G expects the Chairman to meet the service condition.

For the year ended 31 December 20X1 G recognises an expense of £2,500 ( $1,000 \times £5 \times 1/2$ ).

During the third quarter of 20X2 G's share price falls to £10. The remuneration committee meets on 1 October 20X2 and decides to remove the share price target. All other aspects of the award are unchanged.

This is a beneficial modification.

At the date of the modification, the fair value of the **modified** award is £10 and the fair value of the **original** award is £1.

The expense recognised in 20X2 is as follows

		£
Remaining portion of the original fair value over the original vesting period	$1,000 \times £5 \times 1/2$	2,500
Incremental fair value of the modification, recognised over the remaining vesting period (in this example the modification did not change the vesting period)	$1,000 \times (£10 - £1) \times 1$	9,000
		<b>11,500</b>

### Cancellations and settlements

26.19 When an equity-settled share-based payment is cancelled or settled the entity accounts for this as an acceleration of vesting. The amount that would otherwise have been recognised for services received over the remaining vesting period is recognised immediately. [FRS102.26.13]

26.20 FRS 102 does not give explicit guidance as to how to account for a share-based payment when an employee does not complete the required period of service, commonly known as a forfeiture. We believe an entity could choose to account for this using the same principles as a failure to meet a non-market vesting condition. This would lead to the truing-up of the cumulative expense to nil, i.e. the reversal, in the current period, of any previously recognised expense. Alternatively an entity could elect to apply the principles of cancellation accounting as the counterparty has failed to provide the required services to allow the award to vest. This would lead to an acceleration of vesting as outlined above.



### Cash-settled share-based payment transactions

26.21 In a cash-settled share-based payment transaction, the fair value of the liability is used to measure the goods and services received and liability incurred. The liability is remeasured at fair value at each reporting date and at the settlement date since this represents the amount of cash ultimately payable by the entity. FRS 102 does not make clear whether, by analogy to the approach used for equity-settled share-based payments (see paragraph 26.8 above), only market conditions and non-vesting conditions should be taken into account when measuring the fair value of the cash-settled liability, or whether all conditions – including service and non-market performance conditions – should be taken into account in determining that fair value. We believe that an entity should choose an accounting policy, to be applied consistently to all cash-settled share-based payments, to measure the fair value of a cash-settled liability using either:

- only market and non-vesting conditions (meaning that service and non-market performance conditions affect the measurement of the liability by adjusting the number of rights to receive cash based on the best estimate of the service and non-market performance conditions that are expected to be satisfied); or
- all vesting and non-vesting conditions, including service conditions and non-market performance conditions.

Changes in fair value are recognised in profit or loss for the period. [FRS102.26.14]

### Share-based payment transactions with cash alternatives

26.22 In July 2015 the FRC issued an amendment to FRS 102, effective for periods commencing on or after 1 January 2015, which amends the requirements relating to share-based payment transactions with cash alternatives. The amendment requires an entity to classify as equity-settled a share-based payment transaction in which the entity has a choice of settlement in cash, or other assets, or by the transfer of equity instruments, unless: the choice of settlement in equity instruments has no commercial substance; or the entity has a past practice or stated policy of settling in cash; or the entity generally settles in cash whenever the counterparty asks for cash settlement, in which case the entity accounts for the transaction as cash-settled. If the counterparty has a choice of settlement, the entity accounts for the transaction as cash-settled unless the choice of settlement in cash (or other assets) has no commercial substance because the cash settlement amount (or value of the other assets) bears no relationship to, and is likely to be lower in value than, the fair value of the equity instruments, in which case the entity accounts for the transaction as equity-settled.

26.23 The July 2015 amendment is applied retrospectively; earlier adoption is permitted. For entities applying the previous version of FRS 102, in earlier accounting periods, when the entity or counterparty has a choice of settlement in cash or equity instruments the share-based payment is accounted for as a cash-settled arrangement, with two exceptions. If the entity has a past practice of settling in equity instruments or the choice of settlement does not have commercial substance (e.g. when the amount of cash settlement offered is not related to and is likely to be lower than the fair value of the equity instrument), the transaction is accounted for as equity-settled. This may lead to some arrangements, such as an award of equity instruments conditional on an IPO or trade sale, being classified as cash-settled share-based payments because the entity has no past practice of settling in equity instruments, despite the entity's expectation to settle the award in equity instruments.

### Group plans

26.24 When an entity grants a share-based payment to employees of other entities in the group, those entities can either measure their share-based payment expense based on a reasonable allocation of the expense for the group or follow the treatment in paragraphs 26.5 to 26.18 of this publication. [FRS102.26.16]

### Government-mandated plans

26.25 In some jurisdictions local law requires that equity investors (which may include employees) are able to acquire equity instruments by providing either no goods or services that are specifically identifiable or ones that are clearly less valuable than the fair value of the equity instruments granted. This indicates that other consideration (such as past or future employee services) has been or will be provided to the entity. These transactions are equity-settled share-based payments. The unidentifiable goods or services received (or to be received) are measured as the difference between the fair value of the share-based payment and of any identifiable goods or services measured at the grant date. [FRS102.26.17]

### Disclosure exemption

26.26 Qualifying entities applying FRS 102 are exempt in their individual financial statements from certain disclosure requirements. See paragraph 3.8 of this publication.

### Transition

26.27 As noted in paragraph 35.20 of this publication, entities previously applying FRS 20/IFRS 2 may continue to apply that standard at the date of transition to equity instruments granted before the transition date or apply this section to those awards. [FRS102.35.10(b)]

26.28 It is likely that this transition relief will be most relevant only to those entities not applying full old UK GAAP or EU-IFRS, for example those previously applying the FRSSE.

## vs previous UK GAAP

### Applicable standards: FRS 20

pUK26.1 The requirements of FRS 20 are identical to those of IFRS 2; see the 'vs EU-IFRS' section

## vs EU-IFRS

### Applicable standards: IFRS 2

#### Scope

IFRS26.1 IFRS 2 specifically excludes from its scope the following arrangements that would otherwise meet the definition of a share-based payment arrangement:

- transactions with employees in their capacity as owners (for example a rights issue);
- equity instruments issued in a business combination in exchange for control of the acquiree; and
- contracts within the scope of IAS 32.8 to 32.10 or IAS 39.5 to 39.7.

#### Measurement

IFRS26.2 The fair value of equity instruments is determined based on market prices, taking into account all the terms and conditions of the award. When market prices are not available, fair value is determined using a valuation technique. IFRS 2 does not include a three-tier measurement hierarchy. In rare cases when the fair value of the equity instruments granted cannot be measured reliably at the measurement date, IFRS 2 allows the use of the intrinsic value of the equity instruments.

#### Share-based payment transactions with cash alternatives

IFRS26.3 Under IFRS 2, when the entity has the choice of settling a share-based payment in cash or equity instruments, it classifies the arrangement as equity-settled unless the choice of settlement in equity instruments has no commercial substance or the entity has a past practice or stated policy of settling in cash. If the counterparty has the choice of settlement then the entity has granted a compound instrument that includes a liability component and an equity component. These are accounted for separately. Under FRS 102, a similar classification arises for awards in which the entity has the choice of settlement. When the counterparty has the choice of settlement the arrangement is classified as wholly cash-settled unless the choice of settlement in cash has no commercial substance because the cash settlement amount bears no relationship to, and is likely to be lower in value than, the fair value of the equity instruments, in which case the entity accounts for the transaction as wholly equity-settled.

#### Cancellations and settlements

IFRS26.4 If the entity or counterparty can choose whether a non-vesting condition is met in an equity-settled share-based payment, then any failure to meet that condition is accounted for as a cancellation: at cancellation any remaining unrecognised grant date fair value is recognised as an immediate expense. If vested equity instruments are repurchased by an entity, then the payment made to the employee is deducted from equity except to the extent the payment exceeds the fair value of the equity instruments repurchased at the repurchase date. Any excess over fair value is recognised as an expense.

IFRS26.5 If, on cancellation, new equity instruments are granted to the employee and identified as a replacement of the cancelled share-based payment, then this is accounted for as a modification of the original share-based payment.

#### Group plans

IFRS26.6 For group plans, IFRS 2 does not allow allocation of an expense between members of a group plan on the basis of a reasonable allocation of the group's expense. IFRS 2 does not include any exemption from its recognition and measurement requirements in respect of group plans.

# 27 Impairment of assets

## OVERVIEW OF REQUIREMENTS

- Section 27 *Impairment of assets* applies to the impairment of assets other than those considered by other sections of FRS 102, e.g. deferred tax assets.
- An impairment test is carried out for inventory at each reporting date. An impairment loss is recognised in profit or loss when the inventory's selling price less costs to complete and sell is lower than its carrying amount at the reporting date.
- For assets other than inventory, the existence of indicators of impairment is assessed at each reporting date. An impairment test is carried out only when an impairment indicator exists.
- An asset's recoverable amount is the higher of its value in use and fair value less costs to sell.
- Impairments of revalued assets are treated as revaluation decreases to the extent that they reverse a revaluation increase, with any remainder recognised in profit or loss.
- Impairment testing is carried out at the asset or cash-generating unit (CGU) level, depending on whether an estimate of recoverable amount can be made at the asset level.
- An impairment loss recognised for a CGU is allocated first to goodwill within the CGU and then pro rata to other assets based on their carrying amounts.
- For the purpose of impairment testing, the carrying amount of a CGU is grossed up to include goodwill attributable to any non-controlling interests.
- If goodwill cannot be allocated to individual CGUs or groups of CGUs on a non-arbitrary basis, it is tested for impairment by determining the recoverable amount of either the acquired entity, if the acquired entity's goodwill has not been integrated, or the entire group of entities if the goodwill relates to an entity that has been integrated.
- Reversal of prior impairment losses for all assets, including goodwill<sup>1</sup>, is permitted in certain instances.

1. For annual periods beginning on or after 1 January 2016, reversal of prior impairment losses for goodwill will no longer be permitted.

## FRS 102

### Section 27

27.1 This section of FRS 102 applies to the impairment of all assets other than those listed below. Their impairment is considered in the other sections indicated:

- (a) Assets arising from construction contracts – see Section 23 *Revenue*.
- (b) Deferred tax assets – see Section 29 *Income tax*.
- (c) Assets arising from employee benefits – see Section 28 *Employee benefits*.
- (d) Financial assets – see Section 11 *Basic financial instruments* or Section 12 *Other financial instruments issues*.
- (e) Investment property measured at fair value – see Section 16 *Investment property*.
- (f) Biological assets related to agricultural activity measured at fair value less estimated costs to sell – see Section 34 *Specialised activities*. [FRS102.27.1]
- (g) Deferred acquisition costs and intangible assets arising from contracts within the scope of FRS 103. [FRS102.27.1A].

#### Impairment of inventories

27.2 At each reporting date an entity assesses whether any inventories are impaired. Impairment is assessed by considering whether the selling price less the costs to complete and sell an item of inventory (or group of inventory items) is greater than its carrying value. [FRS102.27.2] ‘Selling price less the costs to complete and sell’ seems to be consistent with ‘net realisable value’ as referred to in the Regulations (and as previously used in SSAP 9). When it is impracticable to assess items of inventory individually for impairment, items relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area may be grouped. [FRS102.27.3]

27.3 When inventory is impaired the carrying value is reduced to the selling price less costs to complete and sell. The reduction is recognised as an impairment loss immediately in profit or loss. [FRS102.27.2]

27.4 A new assessment of selling price less costs to complete and sell is made at each reporting date. An inventory impairment loss is reversed when either the circumstances that previously caused the impairment no longer exist, or the selling price less costs to complete and sell has increased due to changes in economic circumstances. The amount reversed is limited to the original impairment loss such that the carrying amount of inventory is the lower of cost and the updated selling price less costs to complete and sell. [FRS102.27.4]

#### Impairment of assets other than inventories

27.5 An impairment test is carried out when an impairment indicator exists. The existence of impairment indicators is considered at each reporting date. If an impairment indicator exists, an estimate of recoverable amount is prepared. [FRS102.27.7] When the recoverable amount of an asset is less than its carrying amount, an impairment loss is recognised immediately in profit or loss unless the asset is carried at a revalued amount. If the asset is carried at a revalued amount, the loss is treated as a revaluation loss in accordance with the section of the standard that applies to that asset (see, for example, paragraph 17.23 of this publication). [FRS102.27.6]

27.6 The impairment loss is equal to the difference between the carrying amount and the recoverable amount of the asset. [FRS102.27.5]

27.7 Measuring the recoverable amount of an asset requires an entity to forecast cash flows. When it is not possible to estimate the recoverable amount of the individual asset, e.g. the asset does not generate cash flows individually, the recoverable amount of the CGU to which the asset belongs is estimated. [FRS102.27.8]

27.8 An asset’s CGU is the smallest identifiable group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. [FRS102.27.8]

## Indicators of impairment

27.9 The following sources of information are considered, as a minimum, when assessing if an indicator of impairment may exist: [FRS102.27.9]

### External sources of information

- (a) Significant decline in an asset's market value greater than that which would be expected due to the passage of time or normal use.
- (b) Significant adverse changes in the technological, market, economic or legal environment in which the entity operates have either occurred, or will occur in the near future.
- (c) Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect materially the discount rate used in calculating an asset's value in use and decrease the asset's fair value less costs to sell.
- (d) The carrying amount of the net assets of the entity exceeds the estimated fair value of the entity as a whole.

### Internal sources of information

- (a) There is evidence of obsolescence or physical damage of an asset.
- (b) Significant adverse changes have taken place or are expected to take place in the near future which affect the use of an asset. This includes the asset becoming idle, restructuring or disposal plans, or reassessment of the asset's useful life.
- (c) Evidence from internal reporting that the economic performance of an asset (including operating results and cash flows) is, or will be, worse than expected.

27.10 If there is an indicator of impairment, this may also signify that the entity should review the remaining useful life, the residual value for the asset or the depreciation or amortisation method and, if necessary, adjust them in accordance with the section of FRS 102 applicable to the asset. This may be necessary even if no impairment loss is recognised for the asset.

## Measuring recoverable amount

27.11 The recoverable amount is the higher of an asset's or CGU's fair value less costs to sell and its value in use. [FRS102.27.11]

27.12 If there is no reason to believe that an asset's value in use materially exceeds its fair value less costs to sell, the asset's fair value less costs to sell may be used as its recoverable amount. This will often be the case for an asset that is held for disposal. [FRS102.27.13]

### Fair value less costs to sell

27.13 Fair value (see paragraph 11.90 of this publication for guidance) less costs to sell is the amount obtainable from the sale of an asset or CGU in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. A binding sale agreement in an arm's length transaction or a market price in an active market provides the best evidence of fair value less costs to sell. If there is no binding sale agreement and no active market, then the fair value less costs to sell is determined based on the best information available. Recent transactions for similar assets in the same industry are considered. [FRS102.27.14]

27.14 Any restrictions imposed on an asset are considered in establishing its fair value less costs to sell. If relaxation of these restrictions is required before the asset can be sold then the cost of this relaxation is included in the costs to sell. An asset with a restriction that would affect any purchaser of the asset may have a lower fair value than an asset with no such restriction. [FRS102.27.14A]

27.15 FRS 102 does not provide any definition or guidance on 'costs to sell' but we might expect them, as under IAS 36, to be only the directly incremental costs relating to the disposal of the asset or the CGU, excluding finance costs and income tax expense. Such directly incremental costs are likely to include the legal costs necessary to effect the sale, stamp duty and other transaction taxes, costs necessary to prepare the asset or CGU for its sale and any costs to remove the asset or the assets in the CGU.

## Value in use

27.16 Value in use is the present value of the future cash flows expected to be derived from an asset or CGU. This present value calculation involves the following steps:

- (a) estimating the future cash inflows and outflows to be derived from continuing use of the asset or the CGU and from its ultimate disposal; and
- (b) applying the appropriate market-based discount rate to those future cash flows. [FRS102.27.15]

27.17 The following factors are reflected in the calculation of an asset's or CGU's value in use:

- (a) estimating future cash flows expected to be derived from the asset or the CGU;
- (b) estimating possible variations in the amount or timing of those future cash flows;
- (c) reflecting the time value of money, represented by the current market risk-free rate of interest;
- (d) estimating the price for bearing the uncertainty inherent in the asset or the CGU; and
- (e) reflecting other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset or the CGU. [FRS102.27.16]

27.18 The estimates of future cash flows shall include:

- (a) cash inflows from the continuing use of the asset or the CGU;
- (b) cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset or the CGU (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset or the CGU; and
- (c) net cash flows, if any, expected to be received (or paid) for the disposal of the asset or the CGU at the end of its useful life in an arm's length transaction between knowledgeable, willing parties. [FRS102.27.17]

27.19 If available, an entity may wish to use its recent financial budgets or forecasts to estimate the cash flows. To estimate cash flow projections beyond the period covered by the most recent budgets or forecasts, an entity may extrapolate the projections based on the budgets or forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate is justifiable. [FRS102.27.17]

27.20 Estimates of future cash flows do not include cash flows from financing activities or income tax. [FRS102.27.18]

In addition, the estimates of future cash flows do not include those expected to arise from future restructuring to which management is not yet committed, or from improving or enhancing the asset's future performance. [FRS102.27.19]

27.21 Maintenance expenditure and capital expenditure necessary to maintain the performance of an asset are taken into account when estimating the future net cash flows. Therefore, these are treated like day-to-day servicing costs. Assume that a CGU consists of assets with different useful lives, all of which are essential to the ongoing operation of the CGU. In this case, the replacement of assets and components with shorter lives is considered to be part of the day-to-day servicing of the unit when estimating the cash flows of the CGU.

27.22 For example, a company has a CGU that includes a factory with a useful life of 30 years and some machinery with a useful life of six years. In calculating the value in use of the CGU the cash flows will include the cost of replacing the machinery periodically throughout the 30 years as that expenditure is required to maintain the current standard of performance of the CGU.

27.23 Section 27 does not provide any guidance on foreign currency cash flows. The IAS 36 approach of forecasting the cash flows in the foreign currency in which they will be generated and discounted using an appropriate discount rate, taking into account the currency in which they are generated, will be an acceptable approach. The foreign currency present value amount is then retranslated at the spot exchange rate and added to the functional currency cash flow to determine the recoverable amount.

27.24 The discount rate used in the present value calculation is a pre-tax rate that reflects current market assessments of the time value of money, as well as the risks specific to that asset that are not reflected in the cash flows. [FRS102.27.20]



27.25 The discount rate is therefore based on the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those of the asset or CGU. Therefore, the discount rate is based on a market participant's view of the asset or CGU as at the current date. Consequently, although the cash flows in the value in use calculation are entity-specific, the discount rate is not.

27.26 In our experience, it is rare that a discount rate can be observed directly from the market. Therefore, an entity will generally need to build up a market participant discount rate that appropriately reflects the risks associated with the cash flows of the asset or CGU being valued. The entity specific weighted average cost of capital (WACC) or borrowing rate could form the starting point for the calculation of the discount rate that a market participant would use.

27.27 Valuations based solely on cash flows may not be appropriate for assets held for their service potential, such as housing properties held by Registered Social Landlords. For such assets the present value of the future service potential, being the asset's remaining service potential plus net proceeds from disposal, will be more appropriate than cash flows. Suitable measurement models may include calculating value in use by estimating the costs avoided in owning the asset, or the asset's depreciated replacement cost. [FRS102.27.20A]

### Recognising and measuring an impairment loss for a CGU

27.28 An impairment loss is recognised to the extent that the carrying amount of an asset or CGU exceeds its recoverable amount. Any impairment loss is allocated first by writing down the goodwill that is allocated to the CGU (if any) and then pro rata, based on their respective carrying amounts, to the CGU's other assets. However, no asset is written down below the higher of its recoverable amount (if determinable) and zero. Any excess impairment loss in respect of an asset is allocated pro rata to the other assets in the CGU. [FRS102.27.21-23]

27.29 If an impairment loss exceeds the level of goodwill that is allocated to a CGU it may be because other assets in the CGU, for example intangibles or property, plant and equipment, have become impaired. In this case consideration should be given as to whether the impairment should be allocated to individual assets in the CGU.

### Impairment of goodwill – additional requirements

27.30 Goodwill is tested for impairment at the level of a CGU or a group of CGUs. [FRS102.27.24] Goodwill is allocated to CGUs or groups of CGUs that are expected to benefit from the synergies of the business combination from which it arose. [FRS102.27.25]

27.31 Non-controlling interests are measured at the acquisition date at their proportionate share of the acquiree's identifiable net assets, which exclude goodwill. Goodwill attributable to non-controlling interests is not recognised in the parent's consolidated financial statements. Therefore, for the purposes of impairment testing, the carrying amount of goodwill allocated to a CGU or group of CGUs in which there is a non-controlling interest is notionally grossed up to include the unrecognised goodwill attributable to the non-controlling interests. [FRS102.27.26] This amount is then compared to the recoverable amount of the related CGU or group of CGUs. If an impairment of goodwill is required, this is recognised only for the parent's portion of goodwill as the notional NCI interest is ignored.

27.32 If goodwill cannot be allocated to an individual CGU (or group of CGUs) on a non-arbitrary basis, it is then tested for impairment by determining the recoverable amount of either:

- (a) the acquired entity in its entirety, if the goodwill relates to an acquired entity that has not been integrated or dissolved into the reporting entity; or
- (b) the entire group of entities, excluding any entities that have not been integrated, if the goodwill relates to an entity that has been integrated. [FRS102.27.27]

### Reversal of an impairment loss

27.33 An impairment loss is reversed in subsequent periods if, and only if, the reasons for the impairment loss have ceased to apply. [FRS102.27.28] The reversal of impairments is permissible for all previous recorded impairments including goodwill. The July 2015 amendments to FRS 102 change the permitted treatment such that, for periods beginning on or after 1 January 2016, impairments of goodwill will not be reversible in any circumstances. Early-adoption of all the July 2015 amendments to FRS 102 is permitted for periods beginning on or after 1 January 2015 provided that (for companies) the corresponding changes to the Companies Act (as set out in both SI 2015/980 and SI 2016/1672) are also early-adopted.



27.34 When an impairment loss has been recognised previously, the entity assesses at each reporting date whether there is an indication that the impairment loss has reversed. The indications of potential reversal are the opposite of the indications of impairment (see paragraph 27.9 of this publication). If there is such an indication and the recoverable amount of the impaired asset, CGU or group of CGUs subsequently increases, then all or part of the impairment loss is reversed. The procedure for determining that reversal depends on whether the initial impairment was calculated based on the recoverable amount of an individual asset, CGU or a group of CGUs. [FRS102.27.29]

27.35 When the impairment loss was based on the recoverable amount of an individual asset, a revised estimate of recoverable amount is prepared at the current reporting date. The maximum amount of the reversal is the lower of:

- (a) the amount necessary to bring the carrying amount of the asset to its recoverable amount; and
- (b) the amount necessary to restore the asset to its pre-impairment carrying amount less subsequent depreciation or amortisation that would have been recognised.

27.36 As with FRS 11 and IAS 36, an increase in value in use as a result of the passage of time (the cash flows in later years are now subject to less discounting as they are now more current) does not constitute a reversal of impairment losses.

27.37 However, there can be instances when no reversal of an impairment is permitted, for example, when the reason for the recovery of the CGU does not relate to the reason that gave rise to the original impairment. In this case the external event that caused the original impairment has not reversed.

27.38 A reversal of an impairment loss is recognised in profit or loss unless the asset is revalued. If the asset is carried at revalued amount (e.g. the revaluation model for property, plant and equipment) any reversal of an impairment loss of a revalued asset is treated as a revaluation increase in accordance with the relevant section of FRS 102 for property, plant and equipment (see paragraph 17.23 of this publication). [FRS102.27.30(b)]

27.39 The depreciation or amortisation charge for the asset for the remainder of its useful life after the impairment reversal reflects its revised carrying amount, less its residual value (if any). [FRS102.27.30(d)]

27.40 When the impairment loss was calculated based on the recoverable amount of a CGU, a revised estimate of recoverable amount of that CGU is prepared at the current reporting date. If the estimated recoverable amount of the CGU exceeds its carrying amount, that excess is a reversal of an impairment loss. [FRS102.27.31(a),(b)]

27.41 The reversal is allocated first to the assets of the CGU (other than goodwill) pro rata with their carrying amounts, and then to goodwill. The amount of the reversal for any asset is capped in the same way as set out in paragraph 27.35 of this publication. The increases in carrying amount are treated as reversals of impairment losses for individual assets and, are recognised in the same way as set out in paragraph 27.38 of this publication. [FRS102.27.31(b)]

**Example 27.1**

A CGU comprises goodwill, intangibles and property, plant and equipment. As a result of falling oil prices the CGU becomes impaired. The recoverable amount of the CGU falls to £60m, resulting in an impairment loss of £80m, allocated as follows:

Assets	Carrying amount £m	Impairment allocation £m	Updated carrying amount £m
Goodwill	40	(40)	-
Other intangibles	20	(8)	12
PP&E	80	(32)	48
<b>Total</b>	<b>140</b>	<b>(80)</b>	<b>60</b>

After three years, the oil price increases and the recoverable amount of the CGU increases to £90 million. At this point, the carrying value of the other intangibles and PPE is £55m and hence £35m (£90m less £55m) of the impairment loss may be reversed.

Assuming total depreciation over three years for the intangibles and PPE of £30m, their carrying amount, had the impairment not occurred, would together have been £70m.

£15m (£70m less £55m) of the impairment reversal is taken to the carrying amount of other intangibles and the PP&E and the remaining £20m is taken to goodwill<sup>2</sup> (the carrying amount of the goodwill had the impairment not occurred would have been £28m)

27.42 When the reversal cannot be allocated to an asset due to the cap (as explained in paragraph 27.41 of this publication), it is further apportioned to the other assets of the CGU that are not subject to the cap. [FRS102.27.31(d)]

27.43 The depreciation or amortisation for each asset in the CGU is adjusted after the reversal on the same basis as set out in paragraph 27.41 of this publication. [FRS102.27.31(e)]

**Transition**

27.44 No exemption is available from retrospective application of the requirements of this section of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

## vs previous UK GAAP

### Applicable standards: SSAP 9, FRS 11

pUK27.1 FRS 11 applies to purchased goodwill and fixed assets except financial instruments, investment properties, and certain oil exploration assets. It also applies to investments in subsidiaries, associates and joint ventures. The scope of Section 27 is wider and includes inventory. The guidance on the impairment of inventory in previous UK GAAP is contained in the measurement rules of SSAP 9.

pUK27.2 FRS 11 refers to income generating units (IGUs) whereas FRS 102 refers to CGUs. This may lead to differences in practice, e.g. the level at which groups of assets are tested for impairment.

pUK27.3 The requirements as to when an impairment test is performed are similar to FRS 102, except that:

- Annual impairment testing is also required for tangible fixed assets with lives of over 50 years.
- Goodwill and intangible assets being amortised over a period of 20 years or less are tested for impairment at the end of the first full financial year following acquisition but thereafter only if there is an indicator of impairment.
- Annual impairment testing is required for goodwill and other intangible assets that are amortised over a period exceeding 20 years, or that are not amortised.

pUK27.4 When an acquired business is integrated with an existing business, the notional value of pre-existing internally generated goodwill is added to the carrying amount of the IGU for the purposes of performing the impairment test. Any subsequent impairment losses are allocated pro rata between the purchased goodwill and the notional pre-existing internally generated goodwill. Only the amount of the loss allocated against the purchased goodwill is recognised in the financial statements. There is no such requirement in FRS 102, which may result in fewer impairments arising from integrated businesses.

pUK27.5 Under FRS 102 goodwill is allocated to CGUs or groups of CGUs that are expected to benefit from the synergies of the business combination from which it arose. FRS 11 is silent on whether goodwill arising on a business combination can be allocated to any IGUs other than those acquired.

pUK27.6 When an impairment test based on value in use has been performed, the actual cash flows of the IGU are monitored for the next five years. If the actual cash flows fall short of the cash flows forecast in the value in use test such that an impairment loss might have resulted had the actual cash flows been used, the calculations are then re-performed using the actual cash flows. Any additional impairment loss is recognised in the current period.

pUK27.7 The presentation of impairment losses is similar to FRS 102, except that it is necessary to assess whether impairment losses relate to operations and so are charged in arriving at operating profit, or relate to a disposal and thus are recognised as part of the gain or loss on disposal.

pUK27.8 For revalued assets, FRS 11 states that an impairment loss is recognised in the profit and loss account if the loss is caused by a clear consumption of economic benefits. Other impairments of revalued fixed assets are recognised in the statement of total recognised gains and losses until the carrying amount of the asset reaches its depreciated historical cost and thereafter in the profit and loss account. Under FRS 102 all impairment losses of revalued assets are treated as revaluation decreases and so recognised in other comprehensive income to the extent of any previously recognised revaluation increase in respect of that asset. If a revaluation decrease exceeds the accumulated revaluation gains in respect of that asset, the excess is recognised in profit or loss.

pUK27.9 Under FRS 11 an impairment loss is allocated first to goodwill, then to any other intangible assets and then pro rata to tangible assets. FRS 102 requires allocation first to goodwill and then pro rata, based on their respective carrying amounts, to all other assets in the CGU.

pUK27.10 Reversals of impairment losses relating to intangible assets are recognised only if:

- (a) the assets have a readily ascertainable market value and the net realisable value of the assets based on that market value has increased to above the asset's impaired carrying amount; or
- (b) an external event caused the recognition of the impairment loss in a previous period and subsequent external events clearly and demonstrably reverse the effects of that event in a way that was not foreseen in the original impairment calculations.

## vs EU-IFRS

## Applicable standards: IAS 36

IFRS27.1 Goodwill, indefinite-lived intangible assets and intangible assets not yet available for use are tested annually for impairment under IAS 36, regardless of whether there is an indication of impairment.

IFRS27.2 Under IAS 36 assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups thereof – a CGU. A key test is the identification of independent cash inflows. The IFRS Interpretations Committee has confirmed that emphasis is placed on independent cash inflows, rather than net cash flows; therefore, cash outflows in themselves are not relevant; e.g. an individual store location with largely independent sales is a CGU.

IFRS27.3 Under IAS 36, the CGU or group of CGUs to which goodwill is allocated for impairment testing purposes represents the lowest level at which goodwill is monitored for internal management purposes, and cannot be larger than an operating segment before aggregation as defined by IFRS 8.

IFRS27.4 Under IAS 36, goodwill cannot always be allocated on a non-arbitrary basis to an individual CGU, only to groups of CGUs. As a result, the lowest level within the entity at which the goodwill is monitored for internal management purposes may comprise a number of CGUs to which the goodwill relates, but to which it cannot be allocated. In contrast, when goodwill cannot be allocated to an individual CGU (or groups of CGUs) on a non-arbitrary basis under FRS 102, then for the purposes of testing goodwill the entity tests the impairment of goodwill by determining the recoverable amount of either:

- (a) the acquired entity in its entirety, if the goodwill relates to an acquired entity that has not been integrated. Integrated means the acquired business has been restructured or dissolved into the reporting entity or other subsidiaries; or
- (b) the entire group of entities, excluding any entities that have not been integrated, if the goodwill relates to an entity that has been integrated.

IFRS27.5 Under IAS 36 an impairment of goodwill cannot be reversed.

IFRS27.6 IAS 36 provides much more detailed guidance on areas where FRS 102 is silent, e.g. IAS 36 requires cash flow projections for a value in use calculation to be based on most recent financial budgets/forecasts approved by management and that those budgets cannot exceed five years unless a longer period can be justified.

IFRS27.7 IAS 36 has more extensive disclosure requirements than FRS 102.



# 28 Employee benefits

## OVERVIEW OF REQUIREMENTS

- Employee benefits are all types of consideration given to employees (including directors and management). Employee benefits include share-based payments but these are covered in Section 26 *Share-based payment*.
- Employee benefits are classified as either short-term, post-employment, other long-term, or termination benefits.
- Short-term benefits are recognised at the undiscounted amount expected to be paid for the services rendered in the period.
- There are two types of post-employment benefit plan: defined contribution and defined benefit plans.
- Contributions payable to a defined contribution plan are recognised as an expense in the period to which they relate.
- When accounting for defined benefit plans, a net defined benefit liability (or asset) representing the obligations under the plan, net of any plan assets, is recognised.
- Actuarial gains and losses, the difference between the total return on plan assets and the amount included in net interest, and the difference between the total asset ceiling movement and the amount included in net interest are recognised in other comprehensive income. All other costs of a defined benefit plan are recognised in profit or loss.
- When a defined benefit plan is introduced or changed in the period, the net defined benefit liability is adjusted accordingly and the effect of the change is recognised in profit or loss.
- A surplus in a defined benefit plan is recognised as an asset only when the surplus is expected to be recovered through reductions in future contributions or a refund.
- A group defined benefit plan is accounted for by members of the group in line with the contractual agreement or policy in place. If there is no such agreement, the entity legally responsible for the plan recognises its cost and the net defined benefit liability (asset), with other members recognising the cost of their contributions for the period.
- Participation in a multi-employer defined benefit plan (which does not include plans for entities under common control) may be accounted for on a defined contribution basis if insufficient information is available to allow defined benefit accounting.
- Entities in a non-group multi-employer plan, with an agreement to fund the plan deficit, recognise a liability for contributions payable arising under the plan agreement to the extent that they relate to the deficit.
- A liability is recognised for 'other long-term benefits' measured at the net of the present value of the obligation and the fair value of any plan assets at the reporting date.
- Termination benefits are recognised as an expense when incurred. A provision is recognised only when the entity is demonstrably committed to terminating employment before the normal retirement date or offering voluntary redundancy.

## FRS 102

### Section 28

28.1 Employee benefits are all forms of consideration given to employees (including directors and management) in exchange for service rendered. Share-based payment arrangements are covered in Section 26. [FRS102.28.1]

28.2 Four types of employee benefit are covered in this chapter:

- (a) short-term employee benefits – benefits that are expected to be settled wholly before twelve months after the end of the period when the employee services were rendered (excluding termination benefits);
- (b) post-employment benefits – benefits due to employees after the end of their employment (excluding termination benefits and short-term benefits);
- (c) other long-term employee benefits – benefits that are not short-term, termination or post-employment benefits; and
- (d) termination benefits – benefits payable in exchange for employment termination as a result of a decision to terminate an employee's employment before the normal retirement date or as a result of voluntary redundancy. [FRS102.28.1]

#### General recognition principle for all employee benefits

28.3 The cost of employee benefits earned for service rendered to the entity is recognised as a liability and an expense (unless it is capitalised under another section of FRS 102). The liability is recognised net of amounts that were paid in the period, either to the beneficiaries or as contributions to a separate fund. Contributions to an employee benefit fund that is an intermediate payment arrangement are accounted for in accordance with FRS 102.9.33-38 – see paragraphs 9.22 to 9.25 of this publication. If the amount paid exceeds the liability, an asset is recognised only if the entity has the right to reduce future payments or to receive a cash refund as a result of that excess payment. [FRS102.28.3]

#### Short-term employee benefits

28.4 Short-term employee benefits are items such as wages, salaries, national insurance, holiday pay, sick pay, non-monetary benefits (such as housing or free or subsidised goods) and bonuses for which the obligation is expected to be settled wholly within twelve months of the end of the period in which the employee service was provided. [FRS102.28.4] These benefits are measured at the undiscounted amount expected to be paid in exchange for the service rendered in that reporting period. [FRS102.28.5]

#### Short-term compensated absences

28.5 Short-term compensated absences include items such as holiday pay and sick leave. When these absences accumulate, i.e. can be carried forward to future periods, the cost is recognised in the period in which it accrues at the undiscounted amount expected to be paid. The amount is presented as a liability due within one year. [FRS102.28.6] The cost of non-accumulating compensated absences, i.e. those that are lost if not used in the current period, is recognised when the absence occurs. [FRS102.28.7]

#### Example 28.1

##### Accumulating absences

Company A offers its employees 25 days of annual leave. A maximum of five days' unused holiday can be carried forward for another year.

As at the reporting date the company makes its best estimate of the number of days that will be carried forward and measures the short-term benefit based on the expected salary level as at the date the holiday is expected to be taken, on an undiscounted basis. [FRS102.28.5]

As and when employees take holiday in the following period, the holiday carried forward is released first and a further provision is recognised if amounts are carried forward arising from the new entitlement into the following period.

##### Non-accumulating absences

Company B offers its employees a maximum of five paid sick days every year. Any unused entitlement is lost at the end of the year. No provision is recognised as at the reporting date for such non-accumulating compensated absences.

## Profit-sharing and bonus plans

28.6 The cost of a bonus (or profit-share) is recognised when there is a legal or constructive obligation to pay the bonus as a result of past events, and the amount can be estimated reliably. [FRS102.28.8]

### Example 28.2

Company A offers its employees a discretionary bonus as an incentive to complete a major product launch successfully.

Although the entity has no obligation arising from employment contracts there is a constructive obligation as the entity has created a valid expectation in the employees that it will pay them a bonus if the product launch is successful and it therefore has no realistic alternative but to make that payment.

The cost of a short-term bonus plan is recognised over the period during which the related service is received.

### Example 28.3

Company B offers its employees a discretionary annual bonus plan. The amount of the bonus is determined by reference to the performance in each financial year, which ends in December. The payment of the award is deferred to March. Only employees who are in employment at the end of March will receive the bonus. The standard does not consider how to deal with this three-month 'stay period'.

One alternative would be to focus on this being an annual bonus plan, based on performance for the financial year. The three-month period is seen as being principally to enable the entity to determine its financial results and the amount of the bonus. Reflecting these factors, the bonus would be recognised over the twelve month period to the end of December, based on an estimate of the number of employees who will still be with the entity at the end of March and will therefore receive the bonus. Alternatively, more emphasis could be placed on the need for employees still to be in service at the end of March in order to be entitled to the bonus, in which case the bonus would be recognised over the fifteen month period to March. Entities should apply one of these approaches consistently as a policy choice.

## Post-employment benefits

### Distinction between defined contribution plans and defined benefit plans

28.7 Post-employment benefits are items such as pensions, post-employment life assurance and post-employment medical care. Post-employment benefits are provided via post-employment benefit plans that are formal or informal arrangements providing benefits to employees. [FRS102.28.9] Post-employment benefit plans include both funded plans, i.e. those under which an entity pays contributions in advance, usually to a separate entity such as a pension plan, and unfunded plans, i.e. those under which the entity settles the benefits directly as they become payable.

28.8 There are two types of post-employment benefit plan: defined contribution plans and defined benefit plans.

- (a) Defined contribution plans require an employer to make fixed contributions into a separate entity (a fund). The employer has no further legal or constructive obligation to make additional contributions or to guarantee benefits to the employee: the employee bears the risk of the value of the benefit.
- (b) All other post-employment plans are defined benefit plans. They commit an employer to provide a certain level of benefit to employees post-employment. The employer bears both the investment and the actuarial risk of providing those benefits. If the investment or actuarial risk improves or worsens, the employer's obligation decreases or increases accordingly. [FRS102.28.10] If a post-employment benefit plan is not a defined contribution plan then it is a defined benefit plan.

28.9 When an employer takes out an insurance policy to fund a post-employment benefit plan and pays insurance premiums, the plan is accounted for as a defined contribution plan unless the entity has a legal or constructive obligation either to pay or to guarantee the employee benefits directly when they become due. If such a constructive or legal obligation exists, the plan is accounted for as defined benefit plan. [FRS102.28.12]



### Multi-employer and state plans

28.10 A multi-employer plan pools the assets of a defined benefit or defined contribution plan provided by the contributions from multiple entities not under common control. Those assets are then used to provide benefits to the employees of those entities. Contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned. Group plans are discussed in paragraphs 28.15 to 28.20 of this publication. [FRS102.GL]

28.11 A state employee benefit plan is established by legislation to cover entities in a particular industry or category. It is operated by either government or another autonomous agency that is not subject to control or influence by the entity. [FRS102.GL]

28.12 Multi-employer and state plans are classified as defined benefit or defined contribution plans according to the plan's terms, including any constructive obligation that may exist. If insufficient information is available for a multi-employer or state defined benefit plan to enable the entity to adopt defined benefit accounting, the plan is accounted for as a defined contribution plan. [FRS102.28.11] The standard does not give any guidance on how to establish whether the entity's share of the plan can be determined with sufficient reliability to enable it to adopt defined benefit accounting. At a minimum, information would need to be available or be able to be derived on an FRS 102 basis: other factors in the assessment might include the relative size of the entity as a participant in the plan.

28.13 If an entity has been applying defined contribution accounting and, in a subsequent period, sufficient information becomes available to allow it to adopt defined benefit accounting, it recognises its share of the net defined benefit asset or liability. The standard does not include guidance as to how any arising gain or loss should be credited or charged. It could be argued that the gain or loss should be taken to profit or loss as past service cost, as would be done if the change was considered analogous to the introduction of a new plan. Alternatively it could be seen as a change in estimate and therefore treated as a remeasurement in the period, which would result in recognising the gain or loss in other comprehensive income (OCI).

28.14 If an entity has entered into an agreement with the multi-employer plan or state plan that determines how the entity will fund a deficit, e.g. as set out in a recovery plan, the entity recognises a liability, discounted if the effect is material, for the deficit contributions payable that arise from the agreement and the resulting expense in profit or loss. [FRS102.28.11A, 28.13, 28.13A]

### Group plans

28.15 A group plan is a pension plan shared by entities under common control. The terms of a plan will determine whether it is a defined contribution or a defined benefit plan. See paragraph 28.8 of this publication for the difference between defined contribution and defined benefit plans.

28.16 Entities participating in a defined benefit plan shared by entities under common control obtain information about the plan as a whole. The defined benefit obligation of a group plan is recognised on at least one individual entity balance sheet within the group. Individual group entities recognise their share of the cost of the plan in their individual accounts as follows:

- If a contractual agreement or stated policy on charging the plan cost to group entities exists, then each entity recognises its share of plan cost according to this policy. The balance sheet consequences are discussed in the following paragraph.
- If no such agreement exists, then the cost is recognised in the individual accounts of the entity legally responsible for the defined benefit plan. Other group entities recognise the cost equal to their contributions payable for the period. [FRS102.28.38]

28.17 The standard does not specify the content and format of a stated policy. In our view the policy should not be unreasonable in the context of the facts and circumstances of the plan. For example, an allocation pro rata pensionable pay or contributions paid might be appropriate but an allocation of all costs to an entity with only a small proportion of the members might not be.

28.18 The standard does not define what it means by 'the entity legally responsible'. In our view this should be the entity that has the most power under the plan's trust deed, which is usually defined as the principal employer.

28.19 The net defined benefit cost is calculated by reference to both the defined benefit obligation and the fair value of the plan assets. Therefore, the consequence of an entity recognising its share of plan cost under an agreement or policy is that its share of the relevant net defined benefit liability (or asset) is also recognised in its individual financial statements. [FRS102.ACA.76]

28.20 The standard is silent on where the movement of the net defined benefit liability is recognised. The amounts could be recognised in profit or loss or allocated on a reasonable basis between profit or loss and OCI. In our view an entity should establish an accounting policy and apply it on a consistent basis.

#### Post-employment benefits: defined contribution plans

28.21 Contributions payable to defined contribution plans are recognised as an expense in the period to which they relate, unless the cost is required to be recognised under FRS 102 as part of the cost of an asset, e.g. property, plant and equipment. At the period end a liability is recognised for any amounts owed to the plan. If contributions exceed the amount due to the plan, an asset is recognised for the excess. [FRS102.28.13]

28.22 For a plan that is accounted for as a defined contribution plan, a liability for contributions payable not expected to be settled wholly within twelve months is measured at its present value using a discount rate specified in paragraph 28.31 of this publication. The unwinding of the discount is recognised in profit or loss as a finance cost. [FRS102.28.13A]

#### Post-employment benefits: defined benefit plans

28.23 When accounting for defined benefit plans, an entity recognises a net defined benefit liability representing its obligations under the plan net of any plan assets or, subject to recoverability, a net defined benefit asset when the plan is in surplus (see paragraph 28.38 of this publication). The standard explains that the cost of the plan is the net change in the net defined benefit liability during the reporting period. However, changes caused by contributions to the plan will not form part of the cost. [FRS102.28.14]

28.24 The net defined benefit liability is measured as the present value of the defined benefit obligation, as set out in the plan rules, at the reporting date, less the fair value at the reporting date of any plan assets out of which the obligation is to be settled.

#### Plan assets

28.25 Plan assets are assets held by a long-term employee benefit fund and qualifying insurance policies.

28.26 Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting entity) that:

- (a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and
- (b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be returned to the reporting entity, unless either:
  - i. the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or
  - ii. the assets are returned to the reporting entity to reimburse it for employee benefits already paid.

28.27 Qualifying insurance policies are insurance policies issued by an insurer that is not a related party of the reporting entity, if the proceeds of the policy:

- (a) can be used only to pay or fund employee benefits under a defined benefit plan; and
- (b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either:
  - i. the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or
  - ii. the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid. [FRS102.GL]

Since qualifying insurance policies are not held by a separate fund, they are generally held directly by the reporting entity.

28.28 Generally, fair value is determined in accordance with the guidance discussed in paragraph 11.90 of this publication. However, when the asset is an insurance policy that exactly matches the amount and timing of some or all of the pension plan benefits, its fair value is deemed to be the present value of the related obligation. [FRS102.28.15, FRS102.GL]

### Defined benefit obligation

28.29 The defined benefit obligation includes both vested and unvested benefits earned by the employees as a result of service provided in the current and previous periods, as well as the effects of benefit formulae that give greater benefits to later years of service. Such formulae generally lead, in practice, to straight-line attribution of the benefits.

#### Example 28.4

Employees of Company X are entitled to a benefit of 3% of final salary for each year of service before the age of 55.

A benefit of 3% of estimated final salary is attributed to each year up to the age of 55. This is the date when further service by the employee will lead to no material amount of further benefits under the plan. No benefit is attributed to service after that age.

28.30 An obligation exists under a defined benefit plan even if the benefits have not yet vested, e.g. are conditional on future employment. The service before the vesting date creates a constructive obligation. In determining the net defined benefit liability, the probability that some employees will satisfy the vesting conditions and that some will not is considered. The probability that the benefits will vest affects the measurement of the obligation but not its existence. [FRS102.28.26]

28.31 The defined benefit obligation is measured on a discounted present value basis. The discount rate used is the market yield at the reporting date on high quality corporate bonds with a currency and term consistent with the expected period of future payments. If no high quality corporate bonds are available for comparison, the yield of government bonds is used instead. [FRS102.28.17] The standard does not define 'high quality'. However, the term is generally interpreted as meaning at least an AA corporate bond rate.

### Actuarial valuation method

28.32 An entity uses the projected unit credit method to measure the defined benefit obligation. This is an actuarial method that sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation (sometimes known as the accrued benefit method prorated on service or as the benefit/years of service method). [FRS102.GL]

28.33 The projected unit credit method requires actuarial assumptions to be made about, for example, the discount rate, employee turnover, mortality and expected medical cost trends (for defined benefit medical plans). [FRS102.28.18] To ensure that the defined benefit obligation reflects the best estimate of future cash flows, the actuarial assumptions used (including demographic variables such as retirement dates and mortality, and financial variables such as inflation) are unbiased and mutually compatible. [FRS102.28.16]

28.34 FRS 102 does not require an actuarial valuation to be carried out annually or by an independent actuary. If actuarial assumptions have not changed significantly, the most recent actuarial valuation can be adjusted for the changes in demographics, e.g. employee numbers and salary costs. [FRS102.28.20]

### Plan introductions, changes, curtailments and settlements

28.35 When a defined benefit plan is introduced or benefits are changed in the period, the net defined benefit liability is adjusted accordingly. An increase or decrease in the liability is recognised as an expense or income (past service cost) in profit or loss in the period in which the change occurs. [FRS102.28.21]

28.36 A curtailment occurs when an entity reduces either the number of employees covered by the defined benefit plan, e.g. closes it to new entrants, or the benefits it offers. A reduction in benefits would normally be such that a material element of future service by current employees will no longer qualify for benefits, or will qualify for reduced benefits. An example would be freezing the level of pensionable salary used as the basis for calculating future benefits or changing the level of benefits that are available on early retirement.

28.37 Settlements are usually lump-sum cash payments made to, or on behalf of, the plan participants in exchange for the complete extinguishment of their right to receive future benefits from the entity. If the plan is curtailed or settled, the defined benefit obligation is decreased or eliminated, with the resultant gain or loss (including any related change in plan assets) recognised in profit or loss in the period in which the curtailment or settlement occurs.

**Example 28.5**

An entity negotiates with its employees a change to the terms of the pension plan to fix the benefits at current salary level. A binding agreement between the entity and the employees was achieved in principle in November 2015. During a three-month consultation period the employees can decide to accept the change to the plan by either:

- remaining in the plan, albeit with reduced future benefits; or
- remaining in the plan as deferred members but transferring their future benefits into a defined contribution plan.

In our view the change to the plan occurred when the employees and the entity agreed the terms of the arrangement in principle, i.e. in November 2015. At this point in time the entity had no realistic alternative to proceeding with the changes to the plan and has to accept the choices made by the employees at the end of the three-month period.

**Net defined benefit plan asset**

28.38 If the defined benefit obligation is less than the fair value of the plan assets, the plan has a surplus. A surplus is recognised as an asset only when it can be recovered either through a reduction in future contributions or a refund from the plan. [FRS102.28.22]

28.39 FRS 102 does not specify the assumptions to be used in assessing the amount of a surplus recoverable through reduced contributions. The entity will need to review its funding agreement with the plan to assess whether any amount of the surplus is recoverable in this way.

28.40 FRS 102 also does not provide guidance on the circumstances that result in a surplus being considered recoverable through a refund from the plan. The objective is to determine whether the surplus meets the definition of an asset for the entity. The standard does not require there to be an existing agreement with the plan regarding a refund but, in our view, the plan documentation (including any minimum funding requirement) should give the entity access to any surplus at some stage in the plan's life, even if just on eventual wind-up, in order for it to be able to recognise the surplus as an asset.

28.41 Any restriction in the amount of a surplus that can be recognised affects the net interest reported in profit or loss. [FRS102.28.24A,B] Any change in the irrecoverable surplus ('asset ceiling'), excluding amounts included in net interest on the net defined benefit liability or asset, is recognised as a remeasurement in OCI. [FRS102.28.25]

28.42 An entity shall not recognise any additional liabilities to reflect differences between the assumptions used under FRS 102 and those used for the most recent actuarial valuation of the plan for funding purposes (minimum funding requirements). For the avoidance of doubt, no additional liabilities are recognised in respect of an agreement with the defined benefit plan to fund a deficit (such as a schedule of contributions). [FRS102.28.25]

**Recognition of the costs of a defined benefit plan**

28.43 The cost of a defined benefit plan includes:

- (a) the change in the net defined benefit liability from employee service in the reporting period, i.e. current service cost;
- (b) net interest on the net defined benefit liability in the period – measured as the balance sheet net defined benefit liability multiplied by the discount rate, both as determined at the start of the annual reporting period;
- (c) the change in the net defined benefit liability as a result of the introduction of a new plan, a change to the existing plan, a curtailment or a settlement;
- (d) actuarial gains or losses;
- (e) the difference between the actual return on plan assets and the amount included in net interest under (b) above; and
- (f) the change in the amount of a defined benefit plan surplus that is not recoverable (asset ceiling), excluding amounts included in net interest under (b) above. [FRS102.28.23,25]

28.44 The cost of the defined benefit plan arising from (a), (b) and (c) in paragraph 28.43 of this publication is recognised in profit or loss. [FRS102.28.23]

28.45 Some defined benefit plans require employees or third parties to contribute to the costs of the plan. Contributions by employees reduce the cost of the benefits to the entity. [FRS102.28.23] The standard does not specify if the contributions received are recognised in profit or loss or in OCI. In deciding where to recognise these costs an entity should consider what the contributions relate to, i.e. current service costs or deficit funding.

28.46 If defined benefits are reduced for amounts that will be paid to employees by government plans, the defined benefit obligation reflects this only when the government plans are enacted at the reporting date, and past history (or other reliable evidence) indicates that state benefits will change in a predictable manner. [FRS102.28.27]

28.47 The amounts arising from (d), (e) and (f) in paragraph 28.43 of this publication represent the remeasurement of the net defined benefit liability and are recognised in OCI. These costs are not reclassified to profit or loss in a subsequent period. [FRS102.28.25A]

28.48 Actuarial gains and losses are changes in the present value of the defined benefit pension obligation resulting from:

- (a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and
- (b) the effects of changes in actuarial assumptions. [FRS102.GL]

28.49 The actual return on plan assets will reflect movements in fair values during the period, as well as changes made to the portfolio. For example, the loss arising as the difference between the amount paid to purchase an 'exactly matching' insurance policy and the defined benefit obligation to which it relates is recognised in OCI as a remeasurement.

28.50 FRS 102.28 does not specify the treatment of plan administration costs, such as the costs of managing the plan assets. In our view the entity should establish an accounting policy to either:

- (a) recognise the costs of managing plan assets in OCI as part of the overall return on plan assets and any other administration costs in profit or loss; or
- (b) recognise all plan administration costs in profit or loss.

### Reimbursements

28.51 When a reimbursement is virtually certain to be received from a third party to settle a defined benefit obligation, the asset is recognised separately from the liability, i.e. it should not be deducted in arriving at the net defined benefit liability. The asset is dealt with otherwise as if it were a plan asset. As a result, the reimbursement asset is measured at fair value in the same way as for any other plan asset, including measuring a reimbursement asset that is an 'exactly matching' insurance policy at deemed fair value (see paragraph 28.28 of this publication). The net change in the fair value of a recognised reimbursement right is recognised as part of the cost of the related defined benefit plan, with the interest element presented in profit or loss and other movements taken through OCI. [FRS102.28.28] In our view, it is appropriate to present the movements arising from the reimbursement net of the defined benefit costs in profit or loss and OCI respectively.

### Presentation

28.52 When an entity operates more than one plan it is possible that some plans are in surplus and some in deficit. Section 28 does not deal with offsetting. Having regard to the offsetting criteria in Section 11 *Basic financial instruments*, it is possible to offset and present the net amount of a plan surplus or deficit only if the entity currently has a legally enforceable right to use a surplus in one plan to settle obligations in another. [FRS102.11.38A]

### Disclosure

28.53 If an entity participates in a defined benefit plan that shares risks between entities under common control it need not disclose the detailed information about the plan otherwise required but can instead make this disclosure by cross-reference to disclosures in another group entity's financial statements, provided that:

- (a) that group entity's financial statements identify and disclose the information required about the plan separately; and
- (b) that group entity's financial statements are available to users of the reporting entity's own financial statements on the same terms as the financial statements of the entity and at the same time as, or earlier than, the financial statements of the entity. [FRS102.28.41A]

### Other long-term employee benefits

28.54 As for all other types of employee benefit, the cost of other long-term benefits is recognised as the benefit is earned by the employee's services. Examples of other long-term employee benefits include long-term paid absences such as sabbatical leave, benefits for long service, long-term disability benefits, and bonuses or other compensation expected to be paid in part or in full twelve months or more after the end of the period in which they are earned. [FRS102.28.29]

28.55 The liability is measured at the present value of the obligation at the reporting date less the fair value of any plan assets out of which the obligation will be settled. The change in the liability is accounted for in profit or loss or in the cost of an asset when permitted or required by FRS 102. The present value is calculated using a discount rate in line with the method described in paragraph 28.31 of this publication. [FRS102.28.30]

#### Example 28.6

An entity has a three-year annual bonus plan under which employees receive a bonus based on the financial performance of the entity during the first annual reporting period, year 1.

Bonuses are paid 30 days after the end of year 3 to those employees who are still employed by the entity at that date. The benefit is therefore not expected to be settled wholly (or, in this example, even partly) before 12 months after the end of each annual reporting period in which the employee rendered the related service, since it will be settled more than 12 months after the end of each of years 1 and 2.

This arrangement is classified in its entirety as a long-term employee benefit for measurement purposes. The liability is presented in the balance sheet within creditors falling due after more than one year at the end of years 1 and 2, and within creditors falling due within one year at the end of year 3. We believe that the timing of the physical payment of the bonus is not relevant in determining whether the benefit is short-term or long-term – e.g. if part of the bonus is paid on account once the financial statements for years 1 and 2 are authorised for issue.

#### Example 28.7

An entity has a retention plan providing employees with a one-off benefit of 15 additional days of annual leave after they have rendered five years of continuing service to the entity. The additional leave vests only at the end of year 5 – i.e. the employees are not entitled to a portion of the leave before the end of year 5. Such an arrangement is commonly referred to as 'long-service leave'.

Because the employee is only entitled to take the benefit after the end of year 5, this arrangement is classified at the outset and throughout its life as a long-term employee benefit for measurement purposes. The liability is presented in the balance sheet within creditors falling due after more than one year for those employees within the first four years of providing service, and within creditors falling due within one year for employees in year 5 of providing service.

#### Example 28.8

Employees are entitled to 25 days of holiday for each calendar year, which is also the reporting period. Any unused holiday can be carried forward indefinitely. Based on past experience it is expected that some of the unused holiday will be carried forward for a number of years and therefore not settled within 12 months of the end of the reporting period in which the services are provided.

The entity classifies the whole award, not just the element expected to be settled after 12 months, as a long-term employee benefit and measures the liability based on its past experience of how many days' holiday will be carried forward beyond 12 months after the end of the reporting period.

## Termination benefits

28.56 Termination benefits are amounts payable to employees when their employment is terminated. Since termination benefits do not provide an entity with future economic benefits, they are recognised as an expense in profit or loss immediately when incurred. [FRS102.28.32] Termination may also result in a curtailment of retirement benefit obligations. [FRS102.28.33] A provision is created for termination benefits only when the entity is demonstrably committed to terminate employment before the normal retirement date, or to offer voluntary redundancy. [FRS102.28.34] An entity is demonstrably committed when it has a detailed formal plan in place, with no realistic possibility of withdrawal from the plan. [FRS102.28.35] Section 21 *Provisions and contingencies* discusses what may constitute a formal plan (see paragraph 21.75 of this publication).

28.57 Termination benefits are measured at the best estimate of the amount expected to be paid to settle the liability. [FRS102.28.36] When payment is not expected within twelve months after the end of the reporting period, the amount is discounted to present value. The present value is calculated using a discount rate in line with paragraph 28.31 of this publication. [FRS102.28.37]

28.58 Costs related to future services from employees who keep working after the entity has become demonstrably committed to the termination are not termination benefits because the entity is deriving future economic benefits from those services. The costs are therefore spread over the period of future service.

### Example 28.9

Company A offers its sales director a redundancy package of £100,000 if he leaves immediately or a package of £160,000 if he stays for a three month handover period. Assuming he takes the second offer, the additional £60,000 is spread over the three month service period: the £100,000 is recognised as a liability when the entity is demonstrably committed to the termination.

## Transition

28.59 No exemption is available from retrospective application of the requirements of this section of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.



## vs previous UK GAAP

## Applicable standards: FRS 12, FRS 17, UITF 35

pUK28.1 FRS 17 has a narrower scope than FRS 102, dealing only with retirement benefits. There is no specific UK standard that deals with the accounting for short-term employee benefits such as holiday pay and sick pay, although many of these would be covered by the general principles of accounting for provisions (FRS 12).

pUK28.2 Defined benefit multi-employer plans, which include group plans, are accounted for as defined benefit plans other than in two situations:

- Employer contributions are set only in relation to the current service period and any deficit or surplus arising from past service of the entity's own employees or other members of the plan does not affect the current contribution level. In this case the plan is accounted for as a defined contribution plan.
- When the employer contributions are affected by a plan surplus or deficit but the employer cannot identify its share of the assets and liabilities of the plan on a reasonable and consistent basis, the plan is accounted for as a defined contribution plan but with additional disclosure requirements.

pUK28.3 When members of a group participate in a group plan, the second bullet above might apply to some or all of the individual participating entities (including, possibly, the sponsoring entity). They would therefore account for the plan as a defined contribution plan, with additional disclosures. It is therefore possible under FRS 17 that no individual entity within the group would recognise any part of the defined benefit obligation for the plan.

pUK28.4 Obligations arising from deficit-funding agreements for multi-employer plans accounted for on a defined contribution basis are not recognised under previous UK GAAP.

pUK28.5 FRS 17 requires all defined benefit plans to follow the projected unit credit method for valuing the defined benefit obligation. A full actuarial valuation for the plan by a professionally qualified actuary is obtained at least every three years. The actuary updates the most recent valuation to reflect current conditions at each balance sheet date.

pUK28.6 Losses on curtailment or settlement of a plan are measured when the employer becomes demonstrably committed to the transaction and are recognised in profit or loss at that date. Gains are recognised only when irrevocable agreement has been received from all parties that need to agree. The timing of the recognition of these changes under FRS 102 may differ.

pUK28.7 Past service costs (increases in plan liabilities related to employee service in prior periods) arise when an employer makes a commitment to increase the level of benefit provided. They are recognised in profit or loss on a straight-line basis over the period in which the increased benefits vest.

pUK28.8 A defined benefit surplus is recognised to the extent that the employer controls its use either through the right to a refund or a reduction in future contributions. The amount of asset recognised is limited to the amount of refund agreed with the pension plan trustees at the balance sheet date and the present value of future contributions through which the asset could be recovered, measured using the FRS 17 assumptions.

pUK28.9 Under FRS 17 the interest on plan assets is recognised in profit or loss based on the long-term expected rates of return on the assets of the plan.

pUK28.10 Under FRS 17 plan administration costs (plan expenses) are deducted from the long-term expected return on the assets of the plan, which is not an acceptable alternative under FRS 102.

pUK28.11 Under FRSs 17 and 19, the deferred tax asset or liability in relation to a defined benefit pension plan is netted against the related pension liability or asset in the balance sheet.

pUK28.12 FRS 17 mandates the presentation of the defined asset or liability in the balance sheet. Net assets are shown on the face of the balance sheet both before and after the net-of-tax pension asset or liability.

pUK28.13 Reimbursements are not covered by FRS 17. Such assets are dealt with under FRS 12 with any movement on a reimbursement asset recognised in profit or loss. Under certain circumstances the true and fair override of this FRS 3 recognition requirement is applied to recognise some of the movement on the reimbursement asset in the statement of total recognised gains and losses (STRGL).



## vs EU-IFRS

### Applicable standards: IAS 19, IFRIC 14

IFRS28.1 IFRIC 14 includes detailed guidance on calculating the asset ceiling when there are minimum funding requirements, which may in some cases give rise to a reduced asset or an additional liability. The impact is measured using the assumptions made for funding purposes. FRS 102.28.15A states that an entity shall not recognise additional liabilities arising from minimum funding requirements.

IFRS28.2 Under IAS 19, if a termination is linked to a restructuring then the cost and liability are recognised when the entity is demonstrably committed to the restructuring, which may be before a formal plan is in place for the termination.

IFRS28.3 Under IAS 19 a curtailment occurs when an entity significantly reduces the number of employees covered by a plan. All other reductions in benefits are plan amendments. This difference has no practical implications.

IFRS28.4 Under IAS 19 the costs of managing plan assets are recognised in OCI as part of the overall return on plan assets; any other plan administration costs are recognised in profit or loss.

# 29 Income tax

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## OVERVIEW OF REQUIREMENTS

- Current tax is tax payable on taxable profit in relation to the current or previous periods.
  - Deferred tax is future tax payable as a result of transactions in current or previous periods and is recognised for virtually all timing differences, with certain specified exceptions, and for differences arising in a business combination.
  - Deferred tax does not arise on permanent differences.
  - Current and deferred tax is calculated based on applicable rates that have been enacted or substantively enacted at the balance sheet date.
  - Current and deferred tax assets and liabilities are not discounted.
  - Withholding tax is included in the measurement of dividends paid and received; any withholding tax suffered is included in the tax charge.
  - Tax is recognised in the same component of total comprehensive income, or equity, as its related transaction.
  - Deferred tax liabilities are presented within provisions; deferred tax assets are presented within debtors.
  - Current tax assets and liabilities and deferred tax assets and liabilities are each offset if, and only if, there is a legally enforceable right of set-off and intention to settle on a net basis or simultaneously.
  - VAT and similar sales taxes are excluded from the presentation of turnover and expenses. Irrecoverable amounts are disclosed separately.
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## FRS 102

### Section 29

29.1 Income tax includes:

- all domestic and foreign taxes based on taxable profit; and
- tax payable on distributions of a subsidiary, associate or joint venture to the entity. [FRS102.29.1]

29.2 Current tax is tax payable in relation to the current or previous periods. Deferred tax is the future tax payable as a result of transactions in the current or previous periods. [FRS102.29.2]

29.3 Taxes that are not based on taxable profit (for example, PAYE and National Insurance contributions payable based on a percentage of an employee's wages) are not income tax within the scope of this section. In some cases it may not be clear whether a tax or tax benefit is an income tax, in which case judgement will need to be applied in determining the most appropriate accounting treatment, by reference to the features of the particular arrangement. Factors to consider might include:

- whether the charge or benefit is based on a net or gross base figure (e.g. revenue, profit, or units of production);
- whether a benefit is itself taxable or is an additional deduction in arriving at taxable profit;
- whether the receipt, or level, of a benefit is dependent on the entity's tax position.

29.4 One example of this is the UK research and development expenditure credit (RDEC) scheme. We anticipate that, having analysed the details of the scheme in the entity's specific circumstances to determine whether the benefit should be accounted for as a government grant or as income tax, the majority of entities will account for this credit as a government grant under FRS 102. However, an alternative interpretation of FRS 102 could be that 'investment tax credits' (ITCs), such as the RDEC scheme, are always required to be accounted for as tax under FRS 102 since ITCs are scoped out of Section 24 *Government Grants* but are not scoped out of Section 29.

29.5 Although not an income tax, the accounting for VAT is addressed separately in Section 29; see paragraph 29.43 of this publication.

29.6 Tax rates are substantively enacted when it is unlikely that any outstanding stages of the enactment process will affect the outcome as these stages, historically, have had no impact. A UK tax rate is regarded as having been substantively enacted if it is included in either:

- a Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords and Royal Assent; or
- a resolution having statutory effect that has been passed under the Provisional Collection of Taxes Act 1968. [FRS102.GL]

#### Current tax

29.7 A current tax liability is recognised for tax payable for the current and previous periods. If this is less than the amount of tax paid for these periods then a tax asset is recognised. An asset is also recognised if a tax loss can be carried back to relieve tax paid previously. [FRS102.29.3]

29.8 Current tax assets and liabilities, being the entity's estimate of the amount of tax it expects to pay or recover, are calculated using the tax rates enacted or substantively enacted at the balance sheet date (see paragraph 29.6 above). [FRS102.29.5]

29.9 If tax rates vary depending on whether or not a dividend is paid, an entity measures tax at the rate applicable to undistributed profits. When a dividend liability is recognised, the entity also recognises any resulting changes to current (and deferred) tax. [FRS102.29.14]

29.10 Payments to the tax authorities may include interest and penalties as a result of payment later than the due date, e.g. following a dispute with the tax authorities or deliberate late payment for cash flow management purposes. FRS 102 does not specifically address how these should be classified in profit or loss. In the event of deliberate late payment, classification of interest and penalties as financing and operating costs respectively would appear appropriate. In other cases, it may be appropriate to classify interest and penalty charges as part of the current tax charge since:

- the entity will have agreed to the amount of the settlement having regard to the overall amount payable, including the interest/penalties; and
- the interest/penalties are enacted by tax legislation, and can be viewed as component of tax cost to the entity, effectively revising a previous estimate of tax payable.

29.11 Current tax liabilities are not discounted. [FRS102.29.17]

29.12 FRS 102 does not specifically address uncertain tax positions, for example potential obligations that might arise when a particular tax treatment could be challenged by the tax authorities. Although uncertain tax positions are not explicitly addressed in Section 29, they are covered by the general requirement to recognise current tax based on the entity's estimate of the amount of tax it expects to pay or recover. In practice we expect most entities to measure such tax liabilities using their best estimate of the most likely outcome. However, if a range of outcomes is possible or there are a number of individual exposures, it may be appropriate alternatively to use an expected value approach to measuring the liability. The assessment of the amount of tax that the entity expects to pay is made independently of any receipt of an Advance Payment Notice from the tax authorities (issued in the UK to demand payment of tax in advance of the resolution of a disputed tax matter; other jurisdictions may have similar arrangements). Although the disclosure requirements of Section 21 *Provisions and contingencies* would not strictly apply to uncertain tax positions, Section 8 *Notes to the financial statements* requires disclosure in respect of key sources of estimation uncertainty; the entity's exposure to uncertain tax positions might be one such area in which these disclosures are relevant.

29.13 The presentation of current tax is discussed in paragraph 29.37 below.

### Deferred tax

29.14 Deferred tax is determined on a 'timing differences plus' basis under FRS 102, with deferred tax arising on timing differences as well as on the initial recognition of a business combination.

#### Deferred tax on timing differences

29.15 Deferred tax is recognised for timing differences arising when items are included in a tax assessment in one period and recognised in the financial statements in another, [FRS102.29.6] except as follows:

- Deferred tax assets are recognised only to the extent that it is probable they are recoverable against future taxable profits or deferred tax liability reversals. [FRS102.29.7] See paragraph 29.26 below.
- Deferred tax on fixed assets arises when the tax allowance for the asset is received before or after the depreciation is recognised. The deferred tax is reversed if and when all conditions for retaining the tax allowance are met. [FRS102.29.8] An example of the application of this exemption is assets that previously attracted Industrial Buildings Allowances (IBAs) until their phased abolition from 2007 to 2011. As no balancing charge or allowance will arise on the disposal of the asset, deferred tax arises in respect of IBAs received. The depreciation of such assets is treated as a permanent difference (see paragraph 29.21 below).
- Income or expenses from subsidiaries, associates, branches or joint ventures result in deferred tax unless the entity can control the reversal of timing differences and it is probable they will not reverse. [FRS102.29.9] For subsidiaries, branches and joint ventures it is likely (by definition) that the entity will be able to control the reversal of any timing differences, for example taxable distributions of earnings that have been recognised as income in the consolidated financial statements. As an associate relationship does not usually involve control (e.g. over dividend policy), it is more likely that deferred tax should be recognised in respect of the unremitted earnings of an associate.

29.16 Common timing differences include:

- the receipt of capital allowances in excess of, or less than, the related depreciation expense for the period;
- income receivable accrued in the financial statements in one period and taxed on a cash basis in the next;

- provisions recognised in one period in the financial statements that are tax-deductible in later periods when the related expenditure is incurred;
- development expenditure which is tax deductible when incurred but is capitalised in the financial statements;
- pension expenses and actuarial gains and losses recognised in the financial statements for which tax deductions are based on contributions made to the plan;
- revaluation gains in respect of property, plant and equipment.

#### Deferred tax on the initial recognition of a business combination

29.17 Deferred tax also arises in business combinations in respect of any additional tax consequences of any differences between the amount that will be deducted or assessed for tax and the fair value of acquired assets and liabilities, other than in respect of goodwill. There is a corresponding adjustment to goodwill. [FRS102.29.11] Although the standard is silent on the matter, in our view there is also no requirement to recognise deferred tax in respect of any negative goodwill arising in a business combination, given the description of negative goodwill in Section 19 *Business combinations and goodwill*. [FRS 102.19.24]

29.18 Deferred tax may therefore arise in a business combination in respect of assets for which no deferred tax was recognised in the acquired entity's books (for example, if the assets were non-deductible for tax purposes no deferred tax would have been recognised on the cumulative depreciation of the asset).

#### Example 29.1

An asset with a previous book value of £80 is acquired in a business combination. The fair value of the asset is £110. The asset is not deductible for tax in any circumstances. Deferred tax is recognised on acquisition on £110, being the difference between the amount at which the asset is recognised in the consolidated financial statements (the fair value of £110) and the amount deductible for tax purposes (nil), and not solely on the fair value adjustment of £30. A corresponding adjustment is recognised in goodwill.

29.19 In determining the 'amount that will be deducted or assessed for tax' which appears similar to the concept of a 'tax base' in EU-IFRS but is not defined in FRS 102, the entity considers the manner in which it expects, at the end of the reporting period, to recover or settle the carrying amount of the related assets and liabilities. This assessment includes, if appropriate, consideration of all taxes, including operating taxes and taxes arising from the sale of the item, and any indexation allowance attributable to the asset. [FRC CS 121113]

#### Example 29.2

Continuing from example 29.1, assume now that although the asset does not attract capital allowances, a capital gains deduction equal to its original cost of £100 (ignoring indexation) will be available on disposal. The 'amount that will be deducted for tax purposes' would then be £100 if the entity expects to recover the carrying amount of the asset through sale (and a deferred tax liability would arise on the difference of £10 (£110 less £100)). If the entity expects to recover the carrying amount of the asset solely through use and no tax deduction will be available when the asset is scrapped, the 'amount that will be deducted for tax purposes' will be nil and deferred tax will arise on the difference of £110 as in example 29.1 above.

FRS 102 does not specify the required approach to determining the 'amount that will be deducted for tax purposes' for dual use assets (being those that the entity expects to use for a period of time before selling) but a consistent method should be applied over time.

29.20 The concept of the 'amount that will be deducted or assessed for tax' is relevant only for deferred tax on differences arising in a business combination. Timing differences in other circumstances, for example revaluation gains, are instead determined by reference to the amounts that have been recognised in the financial statements and the entity's tax computations respectively. However, the expected manner of settlement or recovery may nevertheless affect the rate at which deferred tax is recognised on timing differences (see paragraphs 29.30 to 29.36 below).

### Permanent differences

29.21 With the exception of differences arising in a business combination, permanent differences do not result in the recognition of deferred tax. These are differences due to items being disallowed for tax purposes or being non-taxable, or the amount of the tax charges or allowances differing from the amount of the related income or expense. [FRS102.29.10] Permanent differences lead to an effective rate of tax that is different from the statutory tax rate.

29.22 One example of a permanent difference is the excess of any expected future tax deduction for an equity-settled share-based payment award over the corresponding cumulative share-based payment expense under FRS 102. [FRS 102.ACA89] No deferred tax is recognised on this difference. However, to the extent that the cumulative share-based payment expense will be tax deductible, a timing difference exists and a potential deferred tax asset arises.

29.23 The amount of the timing difference is the lower of:

- (a) the cumulative share-based payment expense; and
- (b) the cumulative future tax deduction that will be available.

29.24 In the UK, for share-based payments that are share options, a tax deduction is available on the exercise of the option. The future tax deduction is based on the intrinsic value of the best estimate of the number of options that will be exercised in the future, i.e. the number of options currently expected to be exercised at the market price of the shares at the balance sheet date (note that as account is taken in the deferred tax calculation of changes in the expected fulfilment of market conditions, the number of options used in this calculation may be different to that used in the calculation of the share-based payment charge). In our view, this future tax deduction is then adjusted (pro rata) by reference to the expired portion of the vesting period.

29.25 No deferred tax is recognised on any difference between (a) and (b) above.

#### Example 29.3

The cumulative share-based payment expense to date under FRS 102 is £100,000.

The expected total future tax deduction (based on the intrinsic value of the shares under option at the reporting date) is £240,000.

The scheme is two years through a three-year vesting period, hence the proportion of the total expected future tax deduction attributed to the expired period is £160,000 ( $2/3 \times £240,000$ ).

A potential deferred tax asset arises on the timing difference represented by the cumulative share-based payment expense of £100,000. The excess future tax deduction of £60,000 is a permanent difference and no deferred tax is recognised in respect of this.

#### Example 29.4

The cumulative share-based payment expense to date under FRS 102 is £100,000.

The expected total future tax deduction (based on the intrinsic value of the shares under option at the reporting date) is £120,000.

The scheme is two years through a three-year vesting period, hence the proportion of the total expected future tax deduction attributed to the expired period is £80,000 ( $2/3 \times £120,000$ ).

A potential deferred tax asset arises on the timing difference of £80,000, being the amount that will be deductible in the future in respect of the expired portion of the vesting period. The remaining £20,000 of the cumulative share-based payment expense is a permanent difference and no deferred tax is recognised in respect of this.

### Recognition of deferred tax assets

29.26 Deferred tax assets are recognised only to the extent that it is probable they are recoverable against future taxable profits or deferred tax liability reversals. [FRS102.29.7]

29.27 Thus, deferred tax assets are recognised to the extent that a deferred tax liability exists against which the asset will be recovered. The recognition of any asset in excess of such a liability will require consideration of the likelihood of recovery against future taxable profits.

29.28 The existence of unrelieved tax losses is strong evidence that there may not be future taxable profits against which the losses will be relieved. [FRS102.29.7] However, each case will need to be assessed on a facts and circumstances basis. In considering the probability of recoverability of deferred tax assets ‘probable’ means ‘more likely than not’ [FRS102.GL] Situations in which the existence of tax losses may not indicate that future taxable profits will not be available include, for example, when the loss arose from a one-off event that is not expected to recur, or when a restructuring has taken place that will clearly generate taxable profits going forward. There is no ‘bright line’ time threshold beyond which forecast future taxable profits cease to be considered probable; each entity’s forecasts will need to be considered based on its specific circumstances.

29.29 Deferred tax assets often arise in respect of defined benefit pension liabilities. In assessing the recoverability of such assets, it is worth noting that the asset will be recovered through the deductibility of future contributions to the plan, i.e. it will be recovered before any brought forward tax losses. Hence, depending on the entity’s forecast taxable profit before pension contributions, it may be that the deferred tax asset in respect of the pension liability is considered recoverable whilst that in relation to other timing differences or tax losses is not.

### Measurement of deferred tax

29.30 Deferred tax is measured using tax rates enacted or substantively enacted at the balance sheet date (see paragraph 29.6 above) that are expected to be applicable to the reversal of the timing difference. [FRS102.29.12] If different tax rates apply to different profit levels, an entity applies an average expected tax rate. [FRS102.29.13]

29.31 However, if tax rates vary depending on whether or not a dividend is paid, an entity applies the rate when no dividend is paid to calculate deferred tax until it recognises a dividend liability. It then recognises the ensuing changes to deferred tax. [FRS102.29.14]

29.32 Further, deferred tax in relation to revalued fixed assets that are not depreciable (i.e. do not have a limited useful life) and investment properties carried at fair value is measured using the tax rates that apply on sale of the asset. [FRS102.29.15-16]

29.33 Deferred tax on investment properties that have a limited useful life and for which the entity aims to consume substantially all of the property’s economic benefits over time is measured at the substantively enacted tax rates that are expected to apply to the reversal of the timing difference. [FRS102.29.12, 16]

29.34 For depreciable, revalued fixed assets or investment properties that are not measured on the basis of sale of the asset, it will be necessary to consider whether the timing difference will reverse wholly through use of the asset or whether it will reverse partly through use and partly through sale.

29.35 FRS 102 does not specify whether, in measuring deferred tax on a revalued fixed asset acquired other than in a business combination, any indexation allowance is taken into account. In our view, to the extent that the revalued asset is expected to be recovered through sale, it will generally be appropriate to take into account indexation as at the balance sheet date. The resulting deferred tax liability will then be adjusted annually as the indexation allowance increases.

29.36 Deferred tax assets or liabilities are not discounted. [FRS102.29.17]

### Presentation of current and deferred tax

29.37 Current and deferred tax charges and credits are recognised as a tax expense or credit in the same place as the related transaction (i.e. profit or loss (continuing or discontinued), other comprehensive income or equity). [FRS102.29.22]

29.38 In some cases it may be unclear whether, and if so how, a tax expense or credit should be allocated between the performance statements. For example, for current and deferred tax in respect of defined benefit plans, it may be unclear how much relates to the amounts recognised in profit or loss and how much relates to the amounts recognised in other comprehensive income (OCI). In such cases, any reasonable allocation of the tax charge or credit between the relevant performance statements may be made, provided that it is applied consistently over time.

29.39 It is worth noting that whilst deferred tax charges in respect of revaluation gains recognised in OCI will also be recognised in OCI, the reversal of the deferred tax liability will be recognised through profit or loss as the revalued asset is depreciated.

29.40 Deferred tax liabilities are presented within provisions. Deferred tax assets are presented within current assets as debtors, with disclosure of the amount falling due after more than one year if the amount is material. [FRS102.29.23]

29.41 Offsetting of current tax assets and liabilities is allowed only when an entity legally can, and intends to, offset the balances and settle on a net basis or simultaneously. If those conditions are met, offset is required. [FRS102.29.24] Offsetting of deferred tax asset and liabilities is allowed only when an entity has a legal right to offset current tax assets and liabilities, and the deferred tax assets and liabilities relate to taxes levied by the same taxation authority on either the same taxable entity or different taxable entities that intend to settle current tax liabilities and assets either on a net basis or simultaneously. Again, if those conditions are met, offset is required. [FRS102.29.24A]

### Withholding tax on dividends

29.42 The measurement of gross dividends paid and received includes any withholding tax suffered but excludes other taxes e.g. attributable tax credits. [FRS102.29.18-19]

#### Example 29.5

A company declares a dividend of 900. A withholding tax of 10% is applied in the local jurisdiction. The receiving entity is entitled to an attributable tax credit of 20%. The dividend income is recorded at an amount of 900 by the receiving entity, and the withholding tax suffered of 90 is recognised as a tax expense. The dividend income is not grossed up to reflect the effect of the 20% attributable tax credit.

### Value Added Tax (VAT) and other similar sales taxes

29.43 VAT and other similar sales taxes (if recoverable) are excluded from turnover and expenses shown in profit or loss. Irrecoverable amounts are included in the cost of a related asset or the amount of any other separately disclosed related items in the financial statements, when practicable and material. [FRS102.29.20]

### Transition

29.44 There are no exemptions in Section 35 *Transition to FRS 102* from full retrospective application of the requirements of Section 29 on first-time adoption of the standard. Hence deferred tax is recognised on transition in relation to, for example, revalued assets and past business combinations. Deferred tax on revaluations is recognised in the same component of equity as the related revaluation gain. Deferred tax on past business combinations is recognised in retained earnings on transition if the entity has elected not to restate pre-transition business combinations generally as permitted by FRS 102.35.10. If the entity has not taken advantage of the election, and has restated the past business combination, the associated deferred tax would result in an adjustment to goodwill. See also Chapter 35 of this publication.



## vs previous UK GAAP

### Applicable standards: SSAP 5, FRS 16, FRS 19

pUK29.1 FRSs 16 and 19 require all current and deferred tax income or expense for the period to be included in the statements of performance (i.e. profit and loss account or statement of total recognised gains and losses). FRS 102 requires tax to be charged/credited directly to equity if it relates to items that are also charged/credited directly to equity. For example, current tax on share issue costs is recognised in the profit and loss account under FRS 16, but recognised directly in equity under FRS 102.

pUK29.2 The disclosure requirements of FRS 102 differ from those of FRSs 16 and 19. For example, FRS 19 requires a reconciliation of the current tax charge or credit reported in the profit and loss account to profit before tax multiplied by the applicable tax rate, whereas FRS 102 requires a reconciliation of the total tax expense or income for the period (as included in profit or loss). In addition, FRS 102 requires an analysis to be given of the major components of the aggregate tax charge/credit recognised in the financial statements: FRSs 16 and 19 require this analysis to be given separately for tax recognised in profit or loss and OCI. Further, unlike FRS 19, FRS 102 does not require disclosure of movements in deferred tax balances in the period or of unrecognised deferred tax amounts.

pUK29.3 FRS 102 requires disclosure of the net reversal of deferred tax expected to occur in the period following the reporting period. This is not required under FRS 19.

pUK29.4 FRS 102 requires disclosure of the tax expense relating to discontinued operations. [FRS102.5.7D] FRS 16 does not.

pUK29.5 Under FRS 19 deferred tax may be discounted to reflect the time value of money.

pUK29.6 Under FRS 19 deferred tax is recognised on unremitted earnings of subsidiaries, associates and joint ventures only when the income has been accrued or there is a binding agreement in place to distribute the earnings.

pUK29.7 Under FRS 19 deferred tax is not recognised on revaluations of non-monetary assets for which there is no binding agreement to sell and the gain or loss on sale has not been recognised (unless the assets are continuously revalued to fair value through profit or loss).

pUK29.8 Under FRS 19 deferred tax is not recognised on rolled-over gains (arising on revaluations or disposals) until the assets into which the gains have been rolled over are sold.

pUK29.9 Under FRS 19 there is no recognition of deferred tax on fair value adjustments in a business combination unless these would be recognised by the acquired entity in its own financial statements (e.g. on the write down of inventories).

pUK29.10 Under FRSs 17 and 19, the deferred tax asset or liability in relation to a defined benefit pension plan is netted against the related pension liability or asset in the balance sheet.

## vs EU-IFRS

### Applicable standards: IAS 12, SIC-25

IFRS29.1 Under IAS 12 deferred tax is determined on a 'temporary difference' basis rather than the 'timing difference plus' basis of FRS 102. This can result, in some cases, in wider recognition of deferred tax. For example, IAS 12 includes specific guidance on deferred tax on share-based payments, requiring the deferred tax on any excess temporary difference over the cumulative charge to profit or loss to be recognised directly in equity. Under FRS 102 any tax deduction in excess of the profit and loss account charge is treated as a permanent difference and no deferred tax arises on this.

IFRS29.2 Another example of when the recognition of deferred tax under IAS 12 differs from FRS 102 is when legislation changes the amount of future tax relief relating to an asset. Under IAS 12 this would lead to a change in the tax base of the asset and hence a change in the temporary difference and related deferred tax balance. Under FRS 102, the timing difference and related deferred tax balance are unchanged.

IFRS29.3 Under IAS 12 a deferred tax asset may be recognised on a deductible temporary difference arising on the initial recognition of tax-deductible goodwill. Deferred tax may also be recognised on any temporary difference arising on 'negative' goodwill. Under FRS 102 no deferred tax is recognised in relation to the initial recognition of any goodwill (either positive or negative).

IFRS29.4 Under IAS 12, even if the conditions for retaining tax allowances are met, deferred tax is still recognised. Under FRS 102 the deferred tax would be reversed in this situation.

IFRS29.5 IAS 12 specifically requires the consideration of the expected manner of recovery of the asset or settlement of the liability when measuring deferred tax. This is considered only in certain instances under FRS 102.

IFRS29.6 IAS 12 generally includes more detailed disclosure requirements than FRS 102, including information in relation to unrecognised deferred tax amounts. However, FRS 102 requires disclosure of the net reversal of deferred tax expected to occur in the period following the reporting period; this is not required under IAS 12. In addition, FRS 102 requires an analysis to be given of the major components of the aggregate tax charge/credit recognised in the financial statements; IAS 12 is less prescriptive than this and such an analysis is most often given only for tax recognised in profit or loss.

IFRS29.7 IAS 1 requires current tax to be presented separately on the face of the balance sheet; FRS 102 does not.



# 30 Foreign currency translation

## OVERVIEW OF REQUIREMENTS

- This section of FRS 102 applies to transactions in foreign currencies, presentation of financial statements in another currency and translation of foreign operations. Hedge accounting of foreign currency risk is dealt with in Section 12 *Other financial instruments issues*.
- An entity identifies its functional currency as the currency of the primary economic environment in which it operates.
- Primary factors that influence the determination of functional currency are the currencies that mainly influence sales prices, labour costs and material costs.
- Secondary factors include the currencies in which borrowings are denominated and settled, and in which operating cash receipts are normally retained.
- The functional currency of a foreign operation (which may be the same as that of the reporting entity) is determined also by considering the operation's autonomy, cash flows, financing and volume of inter-company transactions.
- The functional currency changes only when the underlying nature of the business has changed. A change in functional currency is accounted for prospectively.
- Foreign currency transactions are translated at the spot rate at the date of the transaction. Monetary items are retranslated at the closing rate at the period end. The profit or loss on retranslation is recognised in the income statement in the period in which it arises unless the monetary item forms part of the net investment in a foreign operation within consolidated financial statements.
- Non-monetary items measured at historical cost are translated at the exchange rate at the date of the transaction. Non-monetary items held at fair value use the exchange rate at the date that the fair value is determined.
- When a monetary item is receivable from or payable to a foreign operation and settlement is neither planned nor likely in the foreseeable future, this is treated as part of the net investment in the foreign operation to reflect the substance of the transaction.
- Foreign exchange differences on retranslation of monetary assets that form part of the net investment in a foreign operation are recognised in other comprehensive income (OCI) in the reporting entity's consolidated financial statements and in profit or loss in either its financial statements or those of the foreign operation, as appropriate.
- Financial statements may be presented in any presentation currency. To translate from functional to presentation currency, assets and liabilities are translated at the closing rate at the balance sheet date and items of income and expense at the exchange rate on the date of the transaction. All resulting exchange differences are taken to OCI. For practical reasons, an average rate for the period may be used to translate items of income and expense. Exchange gains and losses taken to OCI do not need to be recognised in a separate component of equity and are not recycled.
- A foreign operation is translated to the group's presentation currency as noted above. Exchange differences arising are recognised in OCI and are not recycled.

## FRS 102

### Section 30

30.1 This section applies to transactions in foreign currencies and translation of foreign operations. It also deals with how to translate financial statements into a different presentation currency. Hedge accounting of foreign currency risk is covered in Section 12 *Other financial instruments issues*. [FRS102.30.1]

#### Functional currency

30.2 An entity measures its assets, liabilities, equity, income and expenses in its functional currency. All transactions in currencies other than the entity's functional currency are foreign currency transactions. An entity identifies its functional currency as the currency of the primary economic environment in which it operates. This is usually the economic environment in which it primarily generates and expends cash. [FRS102.30.2]

30.3 An entity's functional currency is a matter of fact and not a choice. Judgement may be required when applying the factors below to determine the functional currency.

30.4 The primary factors used to determine an entity's functional currency include:

- (a) The currency that mainly influences:
- i. sales prices;
  - ii. labour and material costs; and
  - iii. any other costs of providing goods or services.

This is often the currency in which sales and costs are denominated and settled.

(b) The currency of the country whose regulations and competitive forces determine sales prices is also an important factor. [FRS102.30.3]

30.5 The secondary factors are consulted when, after having considered the primary factors, the identification of the functional currency is inconclusive. In this case, judgement may be required to identify the functional currency.

30.6 Secondary factors that may also provide evidence of functional currency include:

- the currency in which financing activities occur; and
- the currency in which cash received from operating activities is usually retained. [FRS102.30.4]

#### Example 30.1

Company A was incorporated in and is based in the UK.

- 200,000 of debt is financed in \$ and 10,000 of debt is financed in £
- A's working capital is financed by its operations. These amounts are denominated in £ and other currencies
- Cash reserves are held in \$
- 90% of sales are exported and are priced and denominated in \$
- The majority of operating expenses are priced and denominated in and influenced by £; the balance is in \$.

In this example, A has transactions in both £ and \$. However, A can only have one functional currency.

Under FRS 102, greater weighting is given to the primary factors when determining an entity's functional currency. Considering only the fact pattern above, one may conclude that \$ is A's functional currency.

#### Functional currency of a foreign operation

30.7 A foreign operation is defined as 'an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.' [FRS102.GL]

30.8 As functional currency is determined at an entity level, each entity in a group will have its own functional currency. There is no notion of a group-wide functional currency.

30.9 Foreign operations are sometimes extensions of the reporting entity rather than entities that are operating independently. When considering the functional currency of a foreign operation, it is important to determine whether the foreign operation is closely linked to the reporting entity. If the foreign operation is closely linked or an extension of the reporting entity, its functional currency is the same as that of the reporting entity. In considering the above, a number of additional factors are considered:

- the degree of autonomy of the operation's activities;
- the proportion of transactions with the reporting entity compared with the total transaction volume;
- whether financing needs and cash flows are mainly independent or reliant on the reporting entity; and
- the extent to which cash flows from the operation's activities directly affect, and are readily available for remittance to, the reporting entity. [FRS102.30.5]

30.10 In essence, if a foreign operation is an extension of the reporting entity there is no need to consider the primary and secondary factors in respect of the foreign operation.

### Example 30.2

Company A is incorporated in France and its functional currency is the euro. Its subsidiary B is based in the UK and has three separate operations (L, M and N), which are conducted in the UK with customers external to the group. Each operation generates independent cash flows in different economic environments as the products they offer differ. Separate accounting records are kept for each operation. In our view, the functional currency of each of L, M and N should be assessed separately.

As L, M and N are part of the same legal entity, care should be taken when determining whether each operation could have a different functional currency. If the fact pattern changed and separate accounting records were not maintained for each operation and cash flows were managed on a combined basis, it may not be appropriate to conclude that each operation individually meets the definition of a foreign operation.

### Change in functional currency

30.11 The functional currency of an entity changes only if there has been a change in the underlying nature of the business such that, for example, the currency that mainly influences the sales prices of goods and services has changed. [FRS102.30.15] If the functional currency of an entity changes, the effect is accounted for prospectively. In effect, all monetary and non-monetary items are translated from the old functional currency to the new functional currency using the exchange rate at the date of change. The translated amounts for non-monetary items are then treated as their historical cost. [FRS102.30.16] For accounting purposes the change can only occur at a point in time but, in practice, the change is likely to be a gradual process. In our view, it may be acceptable to account for the change in functional currency from the beginning of the accounting period in which the change occurs, rather than at the specific point of change.

### Example 30.3

Company A's functional currency changed from \$ to £ on 1 January 2015. A also changed its presentation currency from \$ to £ from 1 January 2015.

At 1 January 2015, the statement of financial position is translated from \$ to £ using the exchange rate at that date.

### Reporting foreign currency transactions in the functional currency

#### Initial recognition

30.12 A transaction that requires settlement, or is denominated, in a foreign currency is a foreign currency transaction. Such transactions include the purchase or sale of goods in a foreign currency, borrowing or lending funds in a foreign currency, and the acquisition or disposal of assets in a foreign currency. [FRS102.30.6]

30.13 These transactions are recorded initially in the functional currency by translating the foreign currency amount at the spot exchange rate between the foreign currency and the functional currency at the date of the transaction. [FRS102.30.7] The date

of the transaction is the earliest date that the transaction qualifies for recognition under FRS 102. In practice, it is acceptable for an approximation to the spot rate to be used, such as an average rate for a week or month as an alternative to the spot rate. However, if the exchange rate fluctuates significantly, average rates will not be appropriate. [FRS102.30.8]

30.14 Although the standard allows a choice between the spot or average rate, in our view, the volume and size of the transaction(s) should be considered when determining whether it is appropriate to use the average rate. For example, if there is a steady flow of transactions over a period and the exchange rate has not fluctuated significantly, then it may be appropriate to use an average exchange rate. However, the spot rate may be more appropriate for an entity with an uneven flow of material one-off transactions, or when exchange rates are unstable.

30.15 FRS 102 does not provide guidance on how to determine the average rate and this may be an area of judgement. When calculating an average rate, consideration should be given to the averaging method, i.e. when trading activity is heavily seasonal a simple daily average may not be appropriate.

#### Reporting at the end of the subsequent period

30.16 At each reporting date, foreign currency monetary items are retranslated to the functional currency at the closing rate. [FRS102.30.9] The closing rate is the spot exchange rate at the end of the reporting period. [FRS102.GL] A monetary item is a unit of currency held, or asset or liability that will be received or paid in a fixed or determinable number of units of currency. [FRS102.GL] Examples of monetary items include (but are not limited to) cash, debt, trade receivables, payables and accrued expenses.

30.17 The exchange gain or loss on retranslation or settlement of monetary items is recognised in profit or loss in the period in which it arises. However, if exchange gains or losses arise on monetary items forming part of the entity's net investment in a foreign operation, they are recognised as set out in paragraph 30.23 of this publication. [FRS102.30.10]

30.18 Non-monetary items measured at historical cost are translated at the exchange rate at the date of the transaction. Non-monetary items carried at fair value are retranslated at the exchange rate on the date the fair value was determined. [FRS102.30.9] Examples of non-monetary items include goodwill, prepaid expenses, income received in advance (when no further amounts are to be received), equity securities and share capital (when future payments are undeterminable or not fixed).

30.19 When a gain or loss on a non-monetary item is required under FRS 102 to be recognised in OCI, the foreign exchange element of the gain or loss is also recognised in OCI. Similarly, when the gain or loss is required to be recognised in profit or loss, so is the foreign exchange element of the gain or loss. [FRS102.30.11]

#### Intra-group balances

30.20 Intra-group balances eliminate on consolidation but the related foreign exchange gains or losses do not eliminate. This is because the group as a whole has an exposure to a foreign currency. An entity within the group will need to obtain/sell foreign currency to settle the obligation or receive the proceeds.

#### Example 30.4

Company A has functional currency £, Company B has functional currency \$.

A lends B £1,000 on 30 June 2016.

The exchange rate at 30 June 2016 is £1: \$1.5 and at 31 December 2016 it is £1: \$2.

B will record a loss of \$500 at 31 December 2016:

Company B	30 June 2016 £		31 December 2016 £	
	Dr	Cr	Dr	Cr
Cash	1,500			
Inter-company payable		1,500		500
Exchange loss			500	

A will record the loan on issue:

Company A	30 June 2016	
	£	
	Dr	Cr
Cash		1,000
Inter-company receivable	1,000	

On consolidation, the inter-company receivable and payable eliminate. However, the exchange loss of \$500 remains in the group profit or loss as B will need to repay A and so the group has a foreign currency exposure.

(Note: this example assumes that management of both A and B intend to settle the loan and so the loan is not part of A's net investment in B.)

### Net investment in a foreign operation

30.21 A net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation. [FRS102.GL]

30.22 When a monetary item is receivable from or payable to a foreign operation and settlement is neither planned nor likely to occur in the foreseeable future, this is treated as part of the entity's net investment in the foreign operation to reflect the substance of the transaction. This may include long-term loans or receivables but will not apply to trade payables or trade receivables. [FRS102.30.12]

30.23 In the financial statements that include the reporting entity and the foreign operation (e.g. the reporting entity's consolidated financial statements), the foreign exchange differences on retranslation of such monetary items (see example above) are recognised in OCI and accumulated in equity.

30.24 FRS 102 does not require such exchange differences to be presented separately within equity. These exchange differences are not recycled to profit or loss on disposal of the foreign operation. [FRS102.30.13]

30.25 Exchange differences that arise in the individual or separate financial statements on retranslation of monetary items that form part of a net investment in a foreign operation are recognised in profit or loss of the entity, or of the foreign operation as appropriate. [FRS102.30.13] Section 12 provides further guidance on hedge accounting of foreign currency risk.

#### Example 30.5

Following on from example 30.4, assume the loan is a long-term loan and is considered part of the net investment in a foreign operation.

The foreign currency loss of \$500 in Company B would continue to be recognised through profit or loss in B's individual financial statements. However, the \$500 loss would, in the consolidated financial statements of A, be recognised in OCI rather than profit or loss.

### Use of a presentation currency other than the functional currency

30.26 An entity's presentation currency is 'the currency in which the financial statements are presented'. [FRS102.GL]

30.27 The determination of the functional currency is a matter of fact but the presentation currency can be any currency of choice. When the functional and presentation currencies differ, the balance sheet and items of income and expense are translated into the presentation currency. [FRS102.30.17]

30.28 For example, a company prepares financial statements in sterling but chooses to present those financial statements in US dollars. A group may contain entities with different functional currencies. The items of income and expense and financial position of each entity are translated into the presentation currency for the purposes of the consolidated financial statements.

30.29 If the functional currency is not that of a hyperinflationary economy, the entity translates its functional currency results and financial position to its presentation currency as below:

- Assets and liabilities for each statement of financial position presented (including comparative information) are translated at the closing rate at the respective reporting date.



- All items of income and expense for each statement of comprehensive income (including comparative information) are translated at the exchange rate on the date of the transaction. For practical reasons, an average rate for the respective period may be used to translate items of income and expense. However, this will not be appropriate if the exchange rate has fluctuated significantly in the period. [FRS102.30.19]
- All resulting exchange differences are recognised in OCI. [FRS102.30.18]

30.30 The exchange differences recognised in OCI result from:

- Translating income and expenses at the spot or average rate and assets and liabilities at the closing rate; and
- Translating opening net assets that continue to be recognised at a closing rate different to the previous closing rate.

30.31 Accumulated exchange differences attributable to the non-controlling interest (i.e. exchange differences arising from translation that relate to a foreign operation that is consolidated but not wholly-owned) are recognised as part of non-controlling interest in the consolidated balance sheet. [FRS102.30.20]

30.32 The results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy are first adjusted using the procedures specified in Section 31 *Hyperinflation* (and discussed in Chapter 31 of this publication), and then translated into the presentation currency using the same principles as described in paragraph 30.29 of this publication for non-hyperinflationary functional currencies. [FRS102.30.21]

#### Translation of a foreign operation into the investor's presentation currency

30.33 When consolidating a foreign operation with a functional currency that differs from the group's presentation currency, the results and financial position of the foreign operation are translated into the group's presentation currency as described in paragraph 30.29 of this publication. [FRS102.30.22]

30.34 Normal consolidation procedures apply and intra-group balances and transactions are eliminated. However, the exchange difference arising on an intra-group monetary asset or liability continues to be recognised in profit or loss in the consolidated financial statements, unless it relates to a monetary item forming part of the net investment in a foreign operation, in which case it is recognised in OCI (see paragraph 30.23 of this publication). [FRS102.30.22]

30.35 Goodwill and fair value adjustments arising on acquisition of a foreign operation are treated as assets or liabilities of the foreign operation. They are accounted for in the functional currency of the foreign operation and translated to the presentation currency at the closing rate at each reporting date (see paragraph 30.29 of this publication). [FRS102.30.23]

#### Change in presentation currency

30.36 An entity's choice of presentation currency is an accounting policy choice. A change in presentation currency is therefore a change in accounting policy and is applied retrospectively. This is therefore different to a change in functional currency when prospective application is required.

30.37 If an entity changes its presentation currency, then it presents its financial statements, including comparative amounts, as if the new presentation currency had always been the entity's presentation currency. The same presentation currency is therefore used for all periods presented.

30.38 The translation of comparative information is based on the methods described in paragraphs 30.12 to 30.19 of this publication, unless the functional currency is hyperinflationary:

- Assets and liabilities are translated at the exchange rate at the comparative reporting date.
- Items of income and expense and cash flows relating to transactions arising in previous periods are translated using the spot rate or average rate as appropriate.

30.39 Note that complexities can arise when translating components of equity because, in our view, such items are only translated once at the exchange rates at the dates of the relevant transaction. Therefore, retrospective application for a change in presentation currency may require identification of the individual transactions that gave rise to the equity components and the historic rates applicable to these transactions.

### Example 30.6

Company A has the euro as its presentation currency until the end of 2013. From the beginning of 2014, A changes its presentation currency to £.

In our view, A should translate the 2013 comparatives from the functional currency into sterling by using the appropriate 2013 exchange rates:

- Assets and liabilities are retranslated to the presentation currency at the closing rate at the 2013 year-end.
- Income and expense items are translated at the 2013 average rate.

### Transition

30.40 There are no transition exemptions for foreign currency translation available for first-time adopters of FRS 102. See Chapter 35 of this publication for further guidance on transition.

### vs previous UK GAAP – FRS 26 adopters

Applicable standards: FRS 23, UITF 19, UITF 21, UITF 46

pUK30.1 FRS 26 adopters are required to apply FRS 23. FRS 26 adopters should refer to the 'vs EU-IFRS' section as the requirements of FRS 23 are identical to those of IAS 21. FRS 26 and associated standards are mandatory for entities listed on an EU-regulated market and those applying the fair value accounting rules of the Companies Act.

### vs previous UK GAAP – non-FRS 26 adopters

Applicable standards: SSAP 20, UITF 19, UITF 21

pUK30.2 For entities that do not apply FRS 26, SSAP 20 applies to foreign exchange transactions. Under SSAP 20:

- 'Local currency' is identified whereas FRS 102 uses 'functional currency' but is broadly similar. There is less guidance on the determination of local currency in SSAP 20 compared to the guidance on the determination of functional currency under FRS 102.
- The functional currency of a foreign operation is determined by reference to the cash flows of the undertaking itself, with less regard to the functional currency of the parent.
- The profit and loss account of a foreign operation accounted for under the closing rate/net investment method may be translated to the group's presentation currency at either the actual/average rate or the closing rate.
- Loans to foreign operations that are 'as permanent as equity' are treated in the individual accounts of the investor as non-monetary items and not retranslated.
- When foreign currency borrowings have been used to finance or hedge an investment in a foreign operation, in the individual accounts, provided certain criteria are met, the foreign equity investment may be retranslated each period, with the exchange difference recognised through the statement of total recognised gains and losses together with the appropriate proportion of the exchange difference on the borrowings.
- When a foreign currency transaction is to be settled at a contracted exchange rate or is covered by a related forward contract, the rate of exchange specified in the trade or forward contract may be used to translate the transaction.
- Under SSAP 20, in our view the accounts of a UK company should be presented either in its functional currency or, when that is not sterling anyway, in sterling.

### vs EU-IFRS

Applicable standards: IAS 21, SIC-7, IFRIC 16

IFRS30.1 FRS 102 does not require a foreign currency translation reserve or permit or require recycling.

IFRS30.2 In the consolidated financial statements, exchange differences recognised in OCI that arose on the translation of foreign operations are required to be recognised in a separate component of equity and recycled to profit or loss on disposal of the foreign operation

# 31 Hyperinflation

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## OVERVIEW OF REQUIREMENTS

- Financial statements of entities with a functional currency of a hyperinflationary economy are stated in terms of the measuring unit at the period end using a general price index.
  - Comparatives are restated in terms of the measuring unit current at the reporting date.
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## FRS 102

### Section 31

31.1 When the functional currency is that of a hyperinflationary economy, the financial statements are adjusted for the effects of hyperinflation. There is no absolute inflation rate at which an economy is deemed to be hyperinflationary. Instead, an entity considers all possible indicators of hyperinflation, including but not limited to:

- When a population prefers to keep its wealth in non-monetary assets or in a different stable foreign currency;
- Credit sales and purchases take inflation into account or are quoted in a different stable foreign currency;
- Interest rate, wages and prices are linked to a price index; or
- Cumulative inflation over three years is close to or exceeds 100 percent. [FRS102.31.2]

31.2 The financial statements of an entity with a functional currency of a hyperinflationary economy are presented ('restated') in the measuring unit current at the reporting date. [FRS102.31.3] Restatement is made by way of a general price index that reflects changes in general purchasing power. [FRS102.31.4] To prepare a balance sheet and a statement of profit or loss and other comprehensive income (OCI) in a hyperinflationary economy, an entity needs to determine the impact of changes in purchasing power and restate its comparatives. To prepare these statements, there are four separate steps to be considered.

Step 1: Restate the balance sheet at the beginning of the reporting period.

Step 2: Restate the balance sheet at the end of the reporting period.

Step 3: Restate the statement of profit or loss and OCI for the reporting period.

Step 4: Calculate and separately disclose the gain or loss on the net monetary position.

31.3 In a non-hyperinflationary economy an entity's opening balance sheet is the same as the previous period's closing balance sheet. The current period's closing balance sheet is therefore generally calculated by adding the result for the period to the opening/comparative balance sheet. This is not the case for hyperinflationary financial statements. In preparing hyperinflationary financial statements, the opening balance sheet is required in order to calculate the result for the period (see paragraph 31.8 below). The opening balance sheet must be stated in terms of current purchasing power, i.e. indexed up based on the purchasing power at the end of the current period.

31.4 When preparing an opening balance sheet, adjustments are made to the non-monetary assets and liabilities, monetary assets and liabilities and equity to state them at current purchasing power. That is, even though we are considering the opening balance sheet, the components must be stated based on current purchasing power at the period end.

31.5 There are additional considerations when hyperinflation accounts are prepared for the first time. This chapter focuses on the preparation of hyperinflation accounts on an ongoing basis.

31.6 The closing balance sheet is drawn up so that all amounts also reflect the measuring unit current at the reporting date. Some balance sheet items, i.e. those carried using a year-end valuation methodology, will already reflect the measuring unit current at the reporting date and so will not require restatement. Other items, i.e. those carried at cost or a version of cost, will require restatement. Monetary items are not restated as they already reflect the measuring unit current at the reporting date. [FRS102.31.6]

31.7 The application of the requirements of this chapter are best illustrated through the use of a worked example.

**Example 31.1**

Company X operates in a hyperinflationary economy. This year it has incurred a monthly administrative charge of 10CU and has prepared its historical cost financial statements for the year ended 31 December 2014 as follows:

	1 January 2014 CU	31 December 2014 CU	The consumer price indices are as follows:	
Property, plant and equipment (b)	1,500	1,500	1 January 2000	20
Cash (a)	1,500	1,500	1 April 2008	25
Creditors (a)	-	(120)	1 January 2014	100
	<b>3,000</b>	<b>2,880</b>	31 December 2014	220
Share capital (c)	1,000	1,000	Average for 2014	160
Retained earnings b/f (c)	2,000	2,000		
Loss for the year (d)	-	(120)		
<b>Share capital and reserves</b>	<b>3,000</b>	<b>2,880</b>		

**(a) Monetary items**

31.8 When preparing the opening balance sheet, monetary assets and liabilities must be based on the current purchasing power, i.e. as at the period end.

Company X's opening balance sheet would therefore include:

Cash (1,500 × 220/100) 3,300

In its closing balance sheet, cash would already be recorded at its current purchasing power, i.e. 1500CU.

31.9 Monetary items are not restated at the period end as they already reflect the measuring unit current at the reporting date. [FRS102.31.6]

**(b) Non-monetary items**

31.10 Non-monetary items carried at historical cost, or cost less depreciation and impairment, are restated by applying a general price index from the cost date (or the date the impairment arose) to the reporting period end. The restated amount is reduced if it exceeds its recoverable amount. [FRS102.31.8]

Company X acquired its building on 1 April 2008 for 1,500CU. For the purposes of this example, assume that the building is not depreciated. Non-monetary assets, in the opening and closing balance sheets, must be stated using the purchasing power at the reporting date. As the same purchasing power is being used for both, the carrying amount of the non-monetary asset in both balance sheets will be the same. Company X's opening and closing balance sheet would therefore include:

Property, plant and equipment (1,500 × 220/25) 13,200

31.11 Non-monetary items carried at fair value or net realisable value at the end of the reporting period are not restated as they already reflect the measuring unit current at the reporting date. [FRS102.31.8]

**(c) Share capital and retained earnings**

31.12 Equity, except retained earnings, is restated using a general price index from the date the contributions were made. [FRS102.31.9]

Company X issued share capital of 1,000CU on 1 January 2000.

Share capital is treated in the same way as non-monetary items. Company X's opening and closing balance sheets would therefore include:

Share capital (1,000 × 220/20) 11,000

31.13 The retained earnings are equal to each previous year's surplus indexed from the date earned. Whilst it is calculable, it is a balancing figure in this example.

31.14 Assets or liabilities linked by agreement to changes in prices (e.g. index-linked bonds) are presented at the amount as per the agreement. [FRS102.31.7]

Company X's opening balance sheet under hyperinflationary accounting at 1 January 2014 therefore comprises:

	1 January 2014 CU
Property, plant and equipment (b)	13,200
Cash (a)	3,300
	<b>16,500</b>
Share capital (c)	11,000
Retained earnings b/f	5,500
	<b>16,500</b>

#### (d) Income statement

31.15 Amounts in the statement of comprehensive income (including the income statement) are restated by applying the index from the date of the transaction to the reporting date. An average inflation rate can be used for transactions entered into during the period if general inflation has been even during the period. [FRS102.31.11]

Company X's income statement for the year ended 31 December 2014 would therefore include:

Administrative expenses ((120) × 220/160)	(165)
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31.16 The administrative expenses remain unpaid so Company X has a creditor of 120CU. Since this is a monetary item, it is not restated since it already reflects current purchasing power.

31.17 In a hyperinflationary economy, monetary assets lose value during the period so the financial statements will also include (in profit or loss) a gain or loss on the entity's net monetary position held during the period. This is the loss or gain in purchasing power as a result of the entity holding net monetary assets or monetary liabilities. [FRS102.31.13]

#### (e) Gain or loss on holding monetary items

Company X would record a loss on holding cash of 1,800, (i.e. 3,300 – 1,500) and a gain on holding a creditor of 45 (120 – 165). Its net loss on holding monetary items is 1,755 (1,800 – 45).

Its loss for the year is calculated as follows:

Administrative expenses	(165)
Loss on holding monetary items	(1,755)
<b>Loss for the year</b>	<b>(1,920)</b>

**(f) Statement of cash flows**

31.18 Items in the statement of cash flows are restated to reflect the measuring unit current at the reporting period end. [FRS102.31.12]

Company X's hyperinflation cash flow statement would comprise:

Loss for the year (e)	(1,920)
Loss on holding monetary items (e)	1,755
Change in creditors	165
<b>Cash flows from operating activities</b>	<b>-</b>
Opening cash position at 1/1/14 (a)	3,300
Loss on holding cash (e)	(1,800)
<b>Closing cash position at 31/12/14 (a)</b>	<b>1,500</b>

**(g) Comparative amounts**

31.19 All comparative amounts in the balance sheet, both monetary and non-monetary, are restated in terms of the current period end measuring unit. This is achieved by applying the general price index for the current period to the comparative amounts. [FRS102.31.3] The comparative statement of comprehensive income and statement of cash flows are restated in the same way.

31.20 When financial statements no longer need to be prepared on this basis as the economy has ceased to be hyperinflationary, the amounts expressed in the presentation currency at the end of the previous reporting period become the basis for the carrying amount in the subsequent set of financial statements. [FRS102.31.14]

**Transition**

31.21 No exemption is available from retrospective application of the requirements of this section of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.



### vs previous UK GAAP – FRS 26 adopters

Applicable standards: FRS 23, FRS 24

pUK31.1 FRS 26 adopters should refer to the ‘vs EU-IFRS’ section as the requirements of FRS 23 and FRS 24 are identical to those of IAS 21 and IAS 29 respectively. FRS 26 and associated standards are mandatory for entities listed on an EU-regulated market and those applying the fair value accounting rules of the Companies Act.

### vs previous UK GAAP – non FRS 26 adopters

Applicable standards: SSAP 20, UITF 9

pUK31.2 For entities that do not apply FRS 26, the relevant accounting standards are SSAP 20 and UITF 9. Previous UK GAAP – unlike FRS 102 – provides limited guidance on producing the individual financial statements of an entity with a functional currency of a hyperinflationary economy. More guidance is available when adjustments for inflation are made for the purposes of consolidating a hyperinflationary entity into group financial statements. Under UITF 9, adjustments for consolidation purposes may be made either by adjusting the hyperinflationary currency financial statements to reflect current price levels before the consolidation process is undertaken (i.e. by adopting the current purchasing power method that FRS 102 requires at the individual subsidiary stage already), or by using a relatively stable currency as the deemed functional currency for the relevant foreign operations.

### vs EU-IFRS

Applicable standards: IAS 21, IAS 29, IFRIC 7

IFRS31.1 The principles in FRS 102 are broadly consistent with IAS 29 but FRS 102 contains less guidance on how to apply these principles.

# 32 Events after the end of the reporting period

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## OVERVIEW OF REQUIREMENTS

- The financial statements are adjusted to reflect events that occur after the end of the reporting period, but before the financial statements are authorised for issue, if those events provide evidence of conditions that existed at the end of the reporting period.
  - Financial statements are not adjusted for events that are indicative of conditions that arose after the end of the reporting period, except when the going concern assumption is no longer appropriate.
  - Dividends declared after the end of the reporting period are not recognised as a liability in the financial statements but may be presented as a separate component of retained earnings.
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## FRS 102

### Section 32

32.1 Events that happen between the end of the reporting period and the date on which the financial statements are authorised for issue (not of any earlier public announcement) are defined as ‘events after the end of the reporting period’ and can be favourable or unfavourable. These events fall into two categories: [FRS102.32.2]

- (a) adjusting events – these provide evidence of conditions that existed at the end of the reporting period; and
- (b) non-adjusting events – these are indicative of conditions that arose after the end of the reporting period.

#### Adjusting events after the end of the reporting period

32.2 An entity adjusts its financial statements (amounts and disclosures) after the end of the reporting period for adjusting events. [FRS102.32.4]

32.3 Examples of adjusting events after the end of the reporting period include:

- post period-end settlement of a court case confirming that a present obligation existed at the period-end. [FRS102.32.5(a)]
- confirmation of damages receivable for a court case when judgement was reached before the period-end but the amount was previously not measurable reliably; [FRS102.32.7(b)]
- post period-end information indicating that an asset was impaired at the period end (e.g. customer bankruptcy or sale of inventories after the period-end); [FRS102.32.5(b)]
- confirmation of the cost or proceeds from the purchase/sale of an asset before the period-end; [FRS102.32.5(c)]
- confirmation of the amount of profit share or bonus payable in respect of an obligation existing at the period-end; [FRS102.32.5(d)] and
- detection of fraud or errors indicating the financial statements are incorrect. [FRS102.32.5(e)]

#### Non-adjusting events after the end of the reporting period

32.4 An entity does not adjust the amounts recognised in its financial statements to reflect events after the end of the reporting period that are non-adjusting. [FRS102.32.6] An exception is when events after the end of the reporting period indicate that it is not appropriate for the financial statements to be prepared on a going concern basis. An entity does not prepare its financial statements on a going concern basis if management determines, after the end of the reporting period but before the financial statements are authorised for issue, that it intends or has no alternative other than to liquidate the entity or to stop trading. See paragraph 3.57 of this publication. [FRS102.32.7A,B]

32.5 Examples of non-adjusting events include:

- a post period-end favourable judgement or settlement of a court case such that an amount now becomes receivable, if this would have been only a contingent asset at the period-end, disclosed in accordance with paragraph 21.28 of this publication; and
- post period-end decline in the market value of investments. [FRS102.32.7]

32.6 For each category of non-adjusting event after the end of the reporting period an entity discloses a description of the event and an approximation of its financial impact, or a statement that this cannot be estimated. [FRS102.32.10]

32.7 Examples of non-adjusting events that result in disclosure to reflect information that has come to light after the period-end but before authorisation of the financial statements include:

- a major business combination or disposal of a major subsidiary;
- announcement of a plan to discontinue an operation;
- major purchases, commitments to purchase, disposals or plans to dispose of assets;
- announcement, or commencement of the implementation, of a major restructuring;
- issues or repurchases of an entity’s debt or equity instruments;
- tax rate changes that affect tax assets and liabilities (current and deferred) significantly;
- entering into significant commitments; and
- commencement of major litigation arising from events that occurred after the period end. [FRS102.32.11]

32.8 The classification of creditors as current or non-current (see paragraph 4.6 of this publication) reflects circumstances at the period-end. As such any refinancings, amendments, waivers etc. that are agreed after the period end are not considered in determining the classification of these liabilities as they have not changed, for example, whether the entity had an unconditional right at the reporting date to defer settlement for at least twelve months thereafter.

### Legal claims

32.9 Legal claims can be an area of difficulty given that they can be for amounts that are either receivable or payable, and can result in being either adjusting or non-adjusting events. When a court case settles a claim after the period-end, there can be asymmetry for amounts receivable or payable. For amounts receivable, only a contingent asset exists at the period-end due to the fact that court judgement has yet to be reached. The post period-end court judgment is non-adjusting as there was no asset at the period-end; it was not virtually certain at that date that an asset existed. In contrast, for the amount payable, a provision exists at the period-end (as it was more likely than not that an obligation existed) and the court judgement provides additional evidence about that obligation that existed at the period-end. The amount of the provision is updated as necessary to reflect the court's judgement.

### Asset impairments

32.10 Asset impairments may require careful consideration. For example, just because inventories are sold at lower than period end carrying value does not mean that there is an adjusting event. There could be cases when there is clear evidence that the fall in value occurs after the period end, such as changes in commodity prices after that date, or as the result of a distinct event such as physical damage.

### Dividends

32.11 Dividends in respect of equity instruments declared post period-end are not recognised as a liability since there is no obligation at the period-end. The amount may, however, be presented at the period-end as a separate part of retained earnings. [FRS102.32.8]

### Date of authorisation for issue

32.12 Disclosure is made of the date on which the financial statements are authorised for issue and who gave that authorisation. This disclosure informs the users of the financial statements of the date to which events have been considered. [FRS102.32.9]

32.13 If the entity's owners or others have the power to amend the financial statements after issue, this fact also needs to be disclosed. [FRS102.32.9]

### Transition

32.14 No exemption is available from retrospective application of the requirements of this section of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

vs previous UK GAAP  
Applicable standards: FRS 21

pUK32.1 The requirements of FRS 21 are identical to those of IAS 10 (see 'vs EU-IFRS' section)

vs EU-IFRS  
Applicable standards: IAS 10

IFRS32.1 IAS 10 provides example scenarios for the process of authorising the financial statements for issue.

IFRS32.2 IAS 10 gives many of the same examples for adjusting and non-adjusting events as FRS 102.

# 33 Related party disclosures

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## OVERVIEW OF REQUIREMENTS

- Section 33 includes a definition of a party that is related (a related party) to the reporting entity. This may be a person or an entity. A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.
  - Relationships between a parent and its subsidiaries are disclosed irrespective of whether there have been related party transactions.
  - Key management personnel compensation is disclosed in total unless the reporting entity is a qualifying entity.
  - When related party transactions have occurred, the nature of the related party relationship is disclosed as well as information about the transactions, outstanding balances, and commitments necessary for an understanding of the potential effect of the relationship on the financial statements.
  - Transactions between wholly-owned subsidiaries or with their parents within a group need not be disclosed under this section.
  - An exemption from the disclosure requirements is given for transactions between entities that are related due to state (government) control, joint control or significant influence, or with their controlling state.
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## FRS 102

### Section 33

#### Related party definition

33.1 A person or entity related to the reporting entity is a related party. When considering possible related party relationships the substance and not merely the legal form of the relationship is assessed. In applying the following definition of a related party, it is useful to note that a related party relationship is symmetrical; if A is related to B then B is related to A.

33.2 Part (a) below addresses the case of when a person is a related party and part (b) addresses when an entity is a related party.

- (a) A person or a close member of that person's family (see paragraph 33.5 of this publication) is related to a reporting entity if that person:
- i. has control or joint control over the reporting entity;
  - ii. has significant influence over the reporting entity; or
  - iii. is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.
- (b) An entity is related to a reporting entity if any of the following conditions apply:
- i. the entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others);
  - ii. one entity is an associate or joint venture (or a subsidiary of the associate or joint venture) of the other entity (or of a member of a group of which the other entity is a member);
  - iii. both entities are joint ventures of the same third party;
  - iv. one entity is a joint venture of a third entity and the other entity is an associate of the third entity;
  - v. the entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity;
  - vi. the entity is controlled or jointly controlled by a person identified in (a); or
  - vii. a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity). [FRS102.33.2]

33.3 The definitions of 'control', 'joint control' and 'significant influence' in this context are the same as those in Sections 9 *Consolidated and separate financial statements*, 14 *Investments in associates* and 15 *Investments in joint ventures*.

33.4 In relation to post-employment benefit plans, the standard does not require a specific level of control or influence to be present between the reporting entity and the plan. Consequently, multi-employer or state plans that benefit employees of unrelated entities as well as the reporting entity (and over which the reporting entity does not have control, joint control or significant influence) nevertheless appear to be included within the definition of a related party. An alternative view, given that the standard is not explicit on the point, is to consider a multi-employer or state plan not to be a related party when the reporting entity does not have control, joint control or significant influence over the plan. Although some diversity may emerge in practice in this area, it is worth noting that disclosures will nevertheless be required in respect of pension plans under Section 28 *Employee benefits*.

33.5 Close members of a person's family are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity, and include:

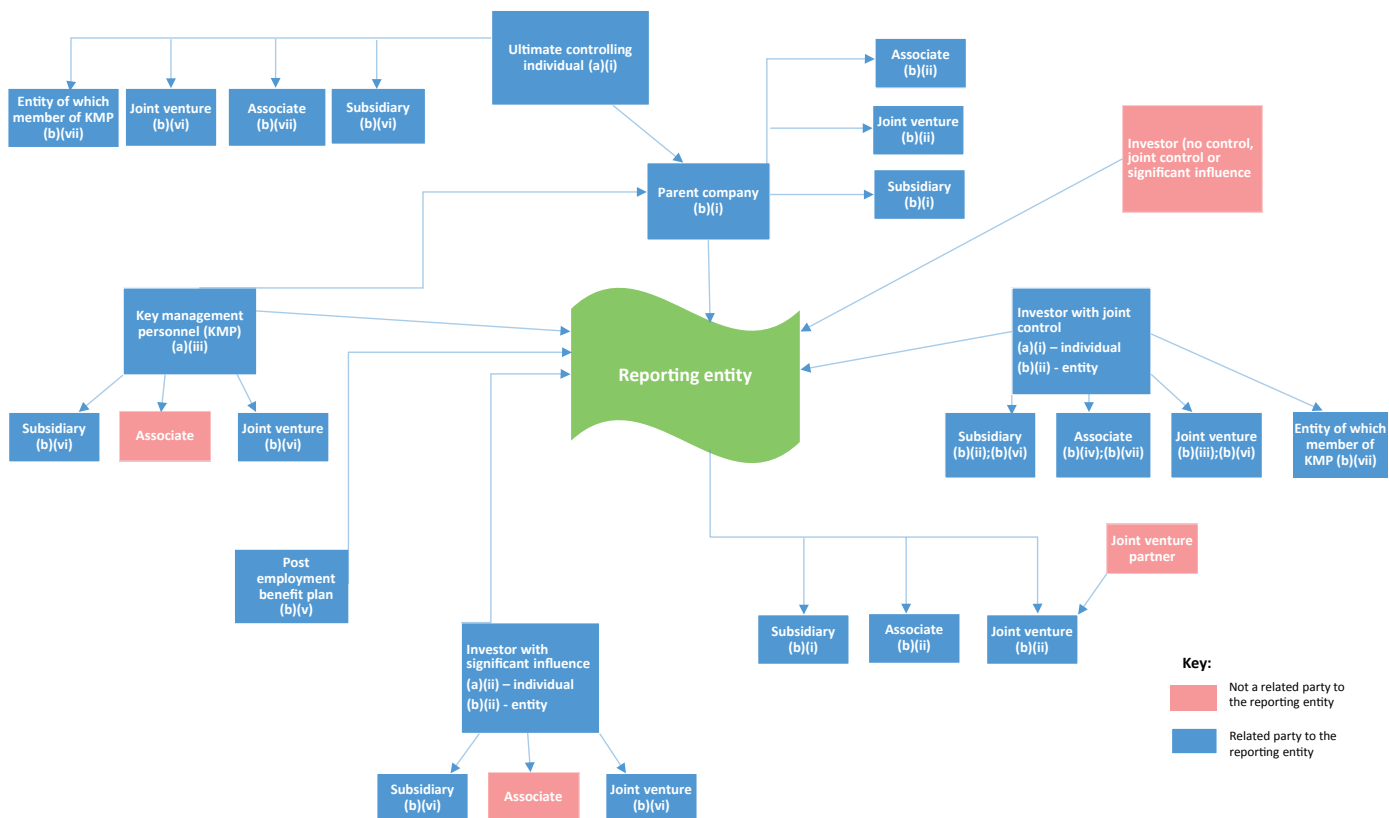
- (a) that person's children and spouse or domestic partner;
- (b) children of that person's spouse or domestic partner; and
- (c) dependants of that person or of that person's spouse or domestic partner.

33.6 The standard does not include a definition of 'children' and, in our view, the term is not limited to minors.

33.7 The following are not necessarily related parties:

- (a) entities with a common member of key management personnel or when a member of key management personnel of one entity has significant influence over the other entity;
- (b) two investors in a joint venture;
- (c) providers of finance, trade unions, public utilities, government departments;
- (d) customers, suppliers, franchisors, distributors or agents on which the entity is economically dependent. [FRS102.33.4]

33.8 Examples of a number of different possible related party relationships as defined above are illustrated below:



**Related party transactions**

33.9 A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged. [FRS102.33.8] Related party transactions could include purchases, sales, or transfers of goods or services; leases; guarantees; and settlements by the entity on behalf of the related party or vice versa. [FRS102.33.8]

33.10 The payment of a dividend to a related party (including members of key management personnel or a controlling shareholder) constitutes a related party transaction, and disclosure would be necessary if the transaction is material (see paragraph 33.30 below). However, the disclosure requirement might be met by disclosures already given elsewhere in the financial statements. For example, if the entity has been wholly-owned throughout the period, and details of the ownership are disclosed, it will be apparent that any dividend will have been paid to the controlling shareholder.

**Parent and subsidiary relationships**

33.11 Relationships between a parent and its subsidiaries are disclosed irrespective of whether there have been related party transactions. The name of the parent is disclosed. Whilst the standard does not specify which parent this disclosure requirement applies to, in our view, given the later reference to the 'next most senior' parent, it is the immediate parent. The name of the ultimate controlling party (if different from the immediate parent) is also disclosed, as well the name of the next



most senior parent that produces publicly available financial statements (if the immediate parent or the ultimate controlling party does not do so). [FRS102.33.5] See also paragraph 33.18 below.

33.12 For companies, whilst the parent-subsidary disclosures required by the Companies Act appear similar to those required by FRS 102, care is needed to ensure that both sets of requirements are met. The Companies Act requirements include disclosure of the largest and smallest group of undertakings for which group financial statements (that include the company) are prepared, as well as disclosure of the ultimate parent undertaking. These may not be the same as the immediate parent and ultimate controlling party under FRS 102; the FRS 102 disclosures refer to the parent preparing publicly available individual financial statements whereas the Companies Act requires disclosure in respect of the parent(s) preparing group financial statements.

### Key management personnel compensation

33.13 FRS 102.33.6 requires disclosure of key management personnel compensation. Key management personnel are those having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity. This definition captures any individual with such responsibilities, regardless of whether they are remunerated by the entity for their services. For example, a director of parent P who also has authority and responsibility for planning, directing and controlling the activities of P's subsidiary S is a member of key management personnel of S even if the director is remunerated only by P.

33.14 In our view, key management personnel also includes directors of any of the entity's parents to the extent that they have authority and responsibility for planning, directing and controlling the entity's activities. When directors of a parent are not considered to be key management personnel of the reporting entity, they are nevertheless a related party of the reporting entity by virtue of FRS 102.33.2(a)(iii), and hence the general requirement to disclose any transactions between the reporting entity and such individuals applies.

33.15 When the reporting entity is a group, the authority and responsibilities of key management personnel are considered in relation to the group's activities. A divisional manager (who is not a director) or a director of a subsidiary (who is not also a director of the parent entity) will, for example, be a member of key management personnel if the division or subsidiary represents a substantial part of the group's activities. A corporate body (e.g. a corporate director) could also be a member of key management personnel.

33.16 Compensation includes all employee benefits, including share-based payments. Employee benefits include consideration paid in exchange for service rendered to the entity, including consideration paid on the entity's behalf or on behalf of the entity's parent. [FRS102.33.6] When key management personnel participate in a defined benefit pension plan, the standard is not specific as to the related amounts that should be disclosed as key management personnel compensation. In our view, it is appropriate to include the proportion of current and past service cost (as determined under Section 28) that relates to key management personnel.

33.17 Key management personnel compensation is disclosed in total, subject to the disclosure exemption for qualifying entities discussed below. [FRS102.33.7] It is worth noting that even if key management personnel comprises only the directors, the directors' remuneration disclosures required under the Companies Act may not be the same as the total of key management personnel compensation required to be disclosed under the standard – the Companies Act, for example, does not require disclosure of the share-based payment expense in relation to directors.

### Disclosures and disclosure exemptions

33.18 Section 33 of FRS 102 requires financial statements to include certain disclosures in order to draw attention to the possible effect of the related party relationship on the entity's financial position and results. [FRS102.33.1]

#### Exemptions

33.19 Qualifying entities (see paragraphs 1.22 to 1.25 of this publication) applying FRS 102 may apply the exemption from the requirement to disclose key management personnel compensation in total. See paragraph 3.8 of this publication.

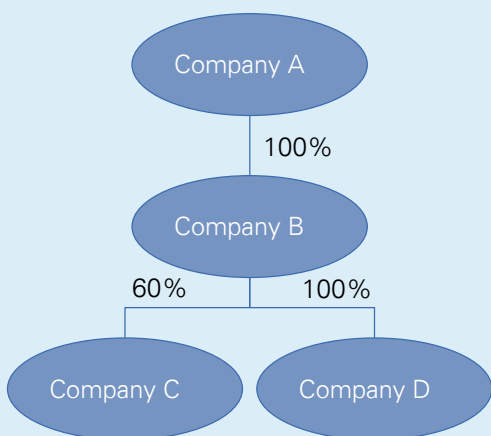
33.20 Although the standard is not specific on the point, intra-group transactions between parents and subsidiaries, and between fellow subsidiaries, will eliminate on consolidation and hence, in our view, no disclosure is required of such intra-group transactions in consolidated financial statements. Transactions between the group and any associates and joint ventures will not be eliminated on consolidation and, subject to materiality, will be disclosed as related party transactions.

33.21 In individual financial statements, transactions between wholly-owned subsidiaries, or with their parent(s), are exempt from disclosure. [FRS102.33.1A]. The exemption does not specifically extend to the disclosure of balances as well as transactions, and it is worth noting that the Companies Act formats (that are required to be applied by all entities applying FRS 102) require disclosure of outstanding balances with group undertakings and with undertakings in which the entity has a participating interest. [FRS102.ACA.93]

33.22 In the case of transactions between fellow subsidiaries, all subsidiaries that are party to the transaction are required to be wholly-owned by a group that includes both of the transacting parties in order to be eligible for the exemption. In our view, 100 percent ownership may be achieved directly or indirectly. In considering the eligibility for this exemption, FRS 102 is unclear as to whether the ownership status is considered as at the date of the transaction or as at the reporting date. In our view, it is appropriate to consider the ownership status as at the transaction date since the aim is to draw attention to the possible effect of the related party relationship at the date the transaction occurred. Examples of the application of this exemption are as follows:

**Example 33.1**

Company A owns 100% of company B, which owns 60% of company C and 100% of company D.



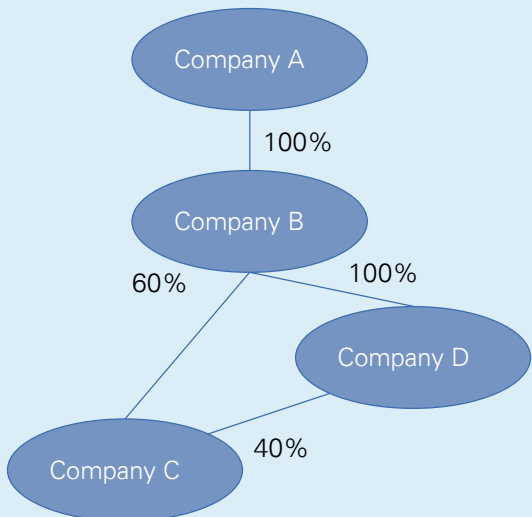
Companies B and D transact with company C. In company B, C and D’s individual financial statements the disclosure exemption does not apply since although company B and D are wholly-owned subsidiaries of company A, company C is not a wholly-owned member of the group that includes company B or company D.

Company A transacts with company C. In company A and C’s individual financial statements the disclosure exemption does not apply since company C is not a wholly-owned member of the group that includes company A.

Any transactions between companies A, B and D would be exempt from disclosure by all parties.

**Example 33.2**

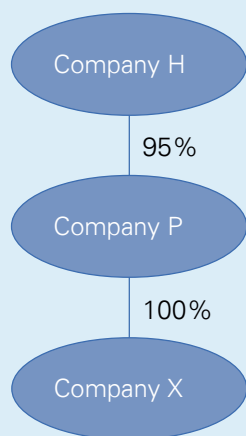
Suppose now that company D owns the remaining 40% of company C.



Company C is now wholly-owned by the group that includes companies A, B and D, and the exemption from disclosure of transactions between companies A, B, C and D may be applied in the individual financial statements of each of those companies.

**Example 33.3**

Company H owns 95% of company P, which owns 100% of company X.



Company H transacts with company P. The disclosure exemption does not apply since company P is not wholly-owned by the group that includes H.

Company H transacts with company X. In the individual financial statements of companies H and X the disclosure exemption does not apply since although company X is wholly-owned by company P, it is not a wholly-owned member of the group that includes H.

Company P transacts with company X. The disclosure exemption may be applied in the individual financial statements of companies P and X since company X is a wholly-owned subsidiary of the group that includes company P.

**Disclosures**

33.23 When related party transactions have occurred, the nature of the related party relationship is disclosed as well as information about the transactions, outstanding balances and commitments necessary for an understanding of the potential effect of the relationship on the financial statements. As a minimum, the following is disclosed:

- (a) the amount of the transactions;
- (b) the amount of outstanding balances; and:
  - i. their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
  - ii. details of any guarantees given or received;
- (c) provisions for uncollectable receivables related to the amount of outstanding balances;
- (d) the expense recognised during the period in respect of bad or doubtful debts due from related parties. [FRS102.33.9]

33.24 The name of the related party is not specifically required to be disclosed under FRS 102, but may be necessary in some cases to provide an understanding of the potential effect of the relationship on the financial statements.

33.25 The disclosures above are made separately for the following categories:

- (a) entities with control, joint control or significant influence over the entity;
- (b) entities over which the entity has control, joint control or significant influence;
- (c) key management personnel of the entity or its parent (in aggregate); and
- (d) other related parties. [FRS102.33.10]

33.26 An exemption from the disclosures in paragraph 33.23 above is given in relation to transactions with:

- (a) a state (a national, regional or local government) that has control, joint control or significant influence over the reporting entity; and
- (b) another entity that is a related party because the same state has control, joint control or significant influence over both the reporting entity and the other entity.

33.27 Parent-subsidary relationships are required to be disclosed.

33.28 It may be stated that related party transactions were made on an arm's length basis only when such a statement can be substantiated. [FRS102.33.13]

33.29 Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity. [FRS102.33.14]

### Materiality

33.30 Disclosure is not required of immaterial transactions. [FRS102.3.16A] FRS 102 does not include specific guidance on materiality in the context of related party transactions, although the FRS 102 glossary definition of materiality states that items are material if they could, individually or collectively, influence the economic decisions of the user taken on the basis of the financial statements. Materiality may be determined by size, by nature, or by a combination of both. Related party transactions that are not significant in monetary terms may be qualitatively material due to their nature. In determining whether disclosure is material, it may be appropriate to consider the significance of the transaction not only to the entity but also to the related party, as well as whether knowledge of the transaction could influence a user's economic decisions.

### Comparatives

33.31 The general requirement of Section 3 *Financial statements presentation* to disclose comparative information applies to related party transactions. Disclosure need be made only in respect of periods in which the parties were related; this question of comparatives often arises when subsidiaries are acquired or disposed of during the year, or when an individual commences or ceases to be a member of key management personnel. To illustrate:

- When a subsidiary is acquired by a group, any transactions between the subsidiary and the group that occurred before the parties became related (i.e. before the date of acquisition) are not related party transactions and are not disclosed.
- When a subsidiary is disposed of by a group, any transactions between the subsidiary and the group that occurred after the disposal date are not related party transactions and are not disclosed. Transactions in the comparative period are disclosed, subject to the disclosure exemptions discussed above.

### Transition

33.32 There are no exemptions available on first-time adoption of FRS 102 from disclosure of related party transactions. Comparative period disclosures are therefore required in accordance with Section 33 of the standard. Transition to FRS 102 is discussed in Chapter 35 of this publication.

## vs previous UK GAAP

### Applicable standards: FRS 8

pUK33.1 The definition of related parties is the same under FRS 8 and FRS 102.

pUK33.2 The wording of the exemption from disclosure of transactions between wholly-owned subsidiaries and parents within a group is not identical between FRS 102 and FRS 8. However, it does not seem that this is intended to create a difference in practice since the wording in both cases is derived from the exemption available under the Companies Act.

pUK33.3 FRS 8 exempts from disclosure those emoluments in respect of service as an employee of the reporting entity: disclosure of key management personnel compensation is not required under previous UK GAAP. Although the Companies Act requires disclosure of directors' remuneration, the definition of key management personnel may be wider than simply the directors of the entity, and the disclosure requirements under the Companies Act are not identical to those of FRS 102.

pUK33.4 Under FRS 8 the name of the related party is disclosed.

pUK33.5 Under FRS 8 there is no exemption for state-controlled entities.

pUK33.6 FRS 8 specifies that in certain circumstances materiality is considered in relation to the related party as well as the reporting entity.

## vs EU-IFRS

### Applicable standards: IAS 24

IFRS33.1 The definition of related parties is the same under IAS 24 and FRS 102.

IFRS33.2 Generally, the disclosure requirements under FRS 102 are similar to the disclosure requirements included in IAS 24.

IFRS33.3 However, some additional disclosures are required under IAS 24:

- key management personnel compensation is also disclosed by category and type of benefit (and no disclosure exemption is available); and
- only partial exemption is given from the disclosure of relationships and transactions with the state and other state-controlled entities.

IFRS33.4 Under IAS 24 there is no disclosure exemption for transactions with wholly-owned subsidiaries and parents within a group.

# 34 Specialised activities

## OVERVIEW OF REQUIREMENTS

- This section of the standard includes specific application requirements for certain specialised activities:
  - agriculture – see Chapter 34A of this publication;
  - extractive activities – see Chapter 34B of this publication;
  - service concession arrangements – see Chapter 34C of this publication;
  - financial institutions – see Chapter 34D of this publication;
  - retirement benefit plans: financial statements – see Chapter 34E of this publication;
  - heritage assets – see Chapter 34F of this publication;
  - funding commitments – see Chapter 34G of this publication; and
  - public benefit entities – see Chapters 34H to 34K of this publication.
- An entity engaged in agricultural activity chooses an accounting policy to measure biological assets and related agricultural produce using either the fair value model or the cost model.
- Heritage assets are broadly accounted for as property, plant and equipment under Section 17 *Property, plant and equipment*, except when information on the cost or value of the asset is not available and cannot be obtained at a cost commensurate with the benefit to users of the financial statements.
- Funding commitments are recognised as a liability once the recognition criteria for a liability are met and the entity cannot realistically withdraw from its commitment. This requirement is not restricted to PBEs.
- A public benefit entity (PBE) is an entity whose primary purpose is for public and social benefit and not to provide a financial return to its shareholders. FRS 102 allows certain departures from normal accounting rules for PBEs. The PBE paragraphs cannot be applied by non-PBEs (Chapter 34H).
- Examples of PBEs include charities, education institutions, local authorities and registered social landlords.
- Non-exchange transactions (Chapter 34I) are those in which an entity receives or gives value to another entity without giving or receiving approximately equal value in exchange. The transactions are recognised in income once any performance conditions have been met.
- Public benefit entity combinations (Chapter 34J) can be at nil consideration and in substance a gift, or meet the definition of a merger. Other combinations are treated in accordance with Section 19 *Business combinations and goodwill*.
- Combinations that are in substance a gift generate a gain (or loss) in income and expenditure.
- Mergers meeting specific conditions are accounted for using merger accounting.
- Concessionary loans (Chapter 34K) are loans at below market rate between a public benefit entity and a third party. They are measured initially either at fair value, and subsequently at amortised cost, or at the amount transferred, and subsequently adjusted for accrued interest.
- In certain sectors PBEs will continue to refer to the relevant SORP for more detailed guidance. The Charities SORP, Housing SORP and Further and Higher Education (FEHE) SORP have all been updated to reflect FRS 102.

**FRS 102****Section 34, PBE11.1A, PBE12.1A, 13.5A, 16.3A, PBE19.2A****Agriculture**

34A.1 Biological assets are living animals or plants. Agricultural produce is the harvested product of the entity's biological assets. Agricultural activity is the management by an entity of the biological transformation of biological assets for sale, into agricultural produce or into additional biological assets. [FRS102.GL]

34A.2 A biological asset or an item of agricultural produce is recognised as an asset by an entity when it is controlled by the entity; it is probable that future economic benefits associated with it will flow to the entity; and its fair value or cost can be measured reliably. [FRS102.34.3]

34A.3 FRS 102 allows an entity engaged in agricultural activity (i.e. one with biological assets) to choose an accounting policy to measure each class of biological asset and its related agricultural produce using either:

- the fair value model; or
- the cost model. [FRS102.34.3A]

However, the Companies Act requires the same accounting policy to be applied to all biological assets. [Companies Act Sch1,Pt2,39.2]

34A.4 If an entity chooses the fair value model for a class of assets, it cannot subsequently change to the cost model. If an entity applying the fair value model cannot measure the fair value of an asset reliably, it applies the cost model to that asset until the fair value can be measured reliably. [FRS102.34.6A]

34A.5 Under the fair value model, biological assets are measured on initial recognition and at each balance sheet date at fair value less costs to sell with changes recognised in profit or loss. [FRS102.34.4] When the biological assets are harvested, the fair value of the related agricultural produce at the date of harvest is treated as its cost when applying Section 13 *Inventories*.

34A.6 Fair value is determined as follows:

- If an active market exists for the biological asset or agricultural produce in its current location and condition, then its quoted price is its fair value.
- If more than one active market exists, fair value is determined by reference to the market that is expected to be used.
- If an active market does not exist, the entity considers whether recent market transaction prices, market prices for similar assets adjusted for differences, or sector benchmarks can be used to determine a reliable estimate of fair value.
- If the above are not available then the entity uses the discounted present value of expected net cash flows, so long as this provides a reliable measure of fair value. [FRS102.34.6]

34A.7 Under the cost model, biological assets are measured at cost less any accumulated depreciation and impairment. [FRS102.34.8] At the date of harvest agricultural produce is measured at either the lower of cost and sales price less costs to sell, or fair value less costs to sell. If fair value is used, any gain or loss arising at the date of harvest is recognised in profit or loss at that time. This is considered to be the cost of the asset when applying Section 13. [FRS102.34.9]

**Transition**

34A.8 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

### vs previous UK GAAP

Applicable standards: SSAP 9, FRS 15

pUK34A.1 Under previous UK GAAP there is no standard dealing specifically with biological assets or agricultural produce. The assets are accounted for using the usual rules for fixed or current assets as applicable. Typically, this results in them being recorded at depreciated cost as fixed assets or as stock at the lower of cost and net realisable value.

### vs EU-IFRS

Applicable standards: IAS 2, IAS 41

IFRS34A.1 Under IAS 41, biological assets are measured at fair value less costs to sell. There is no equivalent of the cost model. IAS 41 includes a presumption that the fair value of biological assets can be measured reliably; a presumption that can only be rebutted on initial recognition.

IFRS34A.2 Agricultural produce is measured at fair value less costs to sell at the point of harvest, considered to be the cost at that date when applying IAS 2.



## Extractive activities

34B.1 An entity engaged in the exploration for and/or evaluation of mineral resources applies IFRS 6 to exploration and evaluation (E&E) expenditure. [FRS102.34.11]

34B.2 IFRS 6 provides specific extractive industry guidance only for the recognition, measurement and disclosure of expenditure incurred on the exploration for, and evaluation of, mineral resources.

34B.3 Expenditure incurred before a legal right to explore is obtained is not E&E expenditure and so may be capitalised only if the expenditure qualified for recognition as an identifiable asset, e.g. an intangible asset in respect of proprietary information that the entity has the ability to control. Similarly, costs incurred after technical and commercial feasibility are demonstrated, e.g. costs incurred on the development or extraction of mineral resources, are not E&E and are accounted for under the sections of FRS 102 relevant to costs of that nature, i.e. Section 13 *Inventories*, Section 17 *Property, plant and equipment* and Section 18 *Intangible assets other than goodwill*.

34B.4 References within IFRS 6 to other IFRSs are instead generally taken as references to the relevant section of FRS 102. [FRS102.34.11A]

34B.5 Entities apply the Oil & Gas SORP when applicable (e.g. when the accounting is not covered by IFRS 6 or elsewhere within FRS 102) and should include a statement to that effect in their financial statements. [FRS100.6] The SORP-making body, the Oil Industry Accounting Committee (OIAC), has indicated that the Oil & Gas SORP will continue to be retained on its website as a reference document, but will not be updated. [FRS100.ACA.22]

34B.6 IFRS 6 indicates that normal impairment guidance will apply, although relief is provided from the general requirements in assessing whether there is any indication of impairment for E&E assets. For the purposes of impairment testing, E&E assets are allocated to cash-generating units (CGUs) or to groups of CGUs (although not at a higher level than an operating segment as defined in FRS 102). E&E assets are assessed for impairment, at the pre-determined level, only when facts and circumstances suggest that the carrying amount of an E&E asset may exceed its recoverable amount, and on transfer of E&E assets to development assets.

## Transition

34B.7 On first-time adoption of FRS 102, if it is deemed impractical to apply a particular requirement of IFRS 6.18 (impairment recognition and measurement) to the previous comparative amounts, an entity shall disclose that fact in the transition disclosures. [FRS102.34.11C]

34B.8 Transition guidance is available if a first-time adopter had previously accounted for exploration and developments costs for oil and gas properties together. This is discussed in paragraph 35.32 of this publication. Transitional relief to analyse assets between E&E and development and extraction assets is set out in FRS 102.35.10(j).

## vs previous UK GAAP

### Applicable standards: Oil & Gas SORP

pUK34B.1 There is no dedicated FRS that deals with exploration or evaluation costs. The OIAC's Oil & Gas SORP provides guidance on the application of general SSAPs and FRSs to costs incurred on oil and gas exploration, development, production and decommissioning. Its guidance regarding exploration and extraction costs is, in the main, consistent with that subsequently developed under IFRS 6. Production and decommissioning costs are considered under the Oil & Gas SORP, although those costs are not in the scope of extractive activities guidance under FRS 102.

## vs EU-IFRS

### Applicable standards: IFRS 6, IFRIC 20

IFRS34B.1 There are no GAAP differences that result directly from this section. When IFRS 6 refers to other IFRSs (and therefore other sections of FRS 102), any GAAP differences are described in that chapter of this publication.

## Service concession arrangements

34C.1 A service concession arrangement is an arrangement whereby a public sector body or a public benefit entity (the grantor) contracts with a private sector entity (the operator) to construct (or upgrade), operate and maintain infrastructure assets for a specified period of time (concession period). The operator is paid for its services over the period of the arrangement. A common feature of a service concession arrangement is the public service nature of the obligation undertaken by the operator, whereby the arrangement contractually obliges the operator to provide services to, or on behalf of, the grantor for the benefit of the public. [FRS102.34.12] Infrastructure assets are defined as infrastructure for public services, such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunications networks. [FRS102.GL]

34C.2 Service concession arrangements are intended to cover arrangements that combine the provision of an asset to the grantor along with the provision of ongoing operational services. Arrangements considered to provide only specific assets to public sector bodies are accounted for as leases under Section 20 *Leases*, or as construction contracts under Section 23 *Revenue*. Arrangements that relate only to the provision of operational services (including those that result in the operator using the grantor's assets) are accounted for under Section 23. It is not intended that service concession arrangements guidance extends its scope beyond the specific type of arrangements that it is intended to cover.

34C.3 An arrangement is within scope when the grantor controls or regulates the services, customers, and pricing relating to the use of the infrastructure and controls any significant residual interest in the infrastructure (through ownership, beneficial entitlement or otherwise) at the end of the term of the arrangement. Situations in which the infrastructure asset is expected to have no significant residual value at the end of the term of the arrangement can still meet the requirement of the grantor controlling the residual interest. [FRS102.34.12A]

34C.4 The ability to control services, customers, and pricing may be demonstrated in a number of ways. With regard to the control of services, the services may be specified through the terms of the concession agreement and/or a licence agreement and/or some other form of regulation. Control of prices (or a price formula) may be set out in the concession arrangement. In other cases, prices may be reset periodically by the grantor, or the grantor may give the operator discretion to set unit prices but set a maximum level of revenue or profit that the operator can retain. Price control by an economic regulator acting in the public interest would also demonstrate price control.

34C.5 Control of the residual interest considers whether the grantor can determine what happens to the infrastructure asset at the end of the service concession arrangement: this is not dependent on which party has the economic benefit in the asset at that point. Control may be demonstrated when the operator is required to return the asset to the grantor or a new operator at the end of the concession; when the grantor holds an option to acquire the asset at the end of the concession; or when the grantor can stipulate to whom the operator should transfer the asset at the end of the concession.

34C.6 Scenarios arise when projects result in services being provided that are partly regulated and partly unregulated. The appropriate analysis of these arrangements would need to be based on their specific facts and circumstances, although the following points are relevant:

- The analysis of whether the project is in scope or not is a binary decision that considers the terms of the arrangements as a whole. As such, subject to the points below, the scope review would need to conclude that the entire project is in scope before concluding that the project could be considered a service concession arrangement to be accounted for in accordance with this guidance.
- Infrastructure that is physically separable and capable of being operated independently should be analysed separately if used wholly for unregulated purposes.
- Purely ancillary activities should be ignored in the analysis.

### Accounting by operators

34C.7 Infrastructure assets operated under service concession arrangements are not recognised as property, plant and equipment (PP&E) by the operator, as the contractual service arrangement does not convey the right to control the use of the public service assets to the operator. [FRS102.34.12] Similarly, existing grantor assets that the operator gains access to as part of the service concession arrangement are not recognised as an asset by the operator as the operator does not have a right to control their use. Arrangements that do not meet the definition of a service concession arrangement are accounted for under normal rules regarding property, plant and equipment (PP&E), intangible assets, leases and revenue, i.e. Sections 17 *Property, plant and equipment*, 18 *Intangible assets other than goodwill*, 20 and 23 respectively. [FRS102.34.12D]

34C.8 The accounting by the operator for the consideration receivable for the construction of the infrastructure asset depends on the nature of the arrangement, and reflects the nature of the consideration receivable from the grantor or the users. There are two categories of service concession arrangement under which the operator receives:

- a financial asset – an unconditional contractual right to receive a specified or determinable amount from, or at the direction of, the grantor in return for constructing (or upgrading) the infrastructure asset and then operating and maintaining it for a specified period. This would include scenarios when the grantor guarantees any shortfall between amounts received from users and a pre-determined target; and/or
- an intangible asset – a right to charge for use of the infrastructure asset that it constructs or upgrades, and then operates and maintains, for a specified period. The amounts received will depend on the extent to which the public uses the service. [FRS102.34.13]

34C.9 A single contract may include both types of arrangement, which would result in both a financial asset and an intangible asset being recognised. [FRS102.34.13]

34C.10 Financial assets and intangible assets relating to the construction services provided under the service concession arrangement are measured initially at fair value with the fair value being based on the fair value of the construction (or upgrade) services provided. The entity subsequently accounts for these assets in accordance with Section 11 *Basic financial instruments* and Section 12 *Other financial instruments issues* for financial assets [FRS102.34.14] and Section 18 for intangible assets. [FRS102.34.15]

34C.11 IFRIC 12 specifies that the operator shall recognise revenue equivalent to the fair value of the construction or upgrade services provided in accordance with IAS 11. FRS 102.34 is silent as to whether revenue should be recognised for the construction or upgrade services provided; rather it indicates that the financial asset or intangible asset recognised will be measured initially at fair value with the fair value being based on the fair value of the construction (or upgrade) services provided. [FRS102.34.15] Arguably the provision of such services would trigger revenue recognition although, as the requirements of FRS 102 are unclear on this question, practice may vary as to whether revenue will be recognised. When revenue is recognised on the construction or upgrade services when an intangible asset is recognised, consistent with IFRIC 12 the total revenue recognised will exceed the total cash received by the operator over the concession period. Revenue would be recognised on the fair value of the intangible asset that arises from the right to charge users and, once operational, revenue will be recognised reflecting receipts from users as they use the infrastructure.

34C.12 The operator applies Section 23 to the revenue it receives for the operating services it performs under the service concession arrangement. [FRS102.34.16]

34C.13 Under the service concession arrangement the operator provides a number of services, although the timing of the cash flows receivable will not typically correspond to those services. As indicated by Section 23, the revenue recognition criteria are applied individually to separately identifiable components of single transactions. In an arrangement in which a financial asset has been recognised, the components will include the principal and interest payments on the financial asset recognised, together with the revenue allocated to the ongoing operating services. The cash flows receivable will need to be allocated across those separate components and, in our view, this allocation should be completed on a relative fair value basis consistent with IFRIC 12, and a common method of allocation in such cases.

34C.14 When an intangible asset is recognised, revenue will be recognised in line with the payment receivable arising from the use of the infrastructure.

34C.15 Service concession agreements typically require the operator to maintain the infrastructure such that the infrastructure can deliver a specified standard of services at all times ('major maintenance'). Judgement may be required to determine whether a particular major maintenance activity undertaken by an operator under the contract is a service provided under the terms of the arrangement, and therefore a revenue-generating activity accounted under Section 23, or just an obligation arising under the terms of the licence to be recognised as a provision under Section 21. When the major maintenance activity is judged to be revenue-generating activity, then in accordance with Section 23, revenue and the costs incurred will be recognised when incurred.

34C.16 Borrowing costs incurred as part of the arrangement will normally be expensed in the period they are incurred. However, in the construction phase when an intangible asset is recognised, the borrowing costs are capitalised if a policy of capitalisation has been adopted. [FRS102.34.16A]

34C.17 When considering the classification of a financial asset, following initial recognition, and specifically whether the criteria of FRS 102.11.9 for recognition as a basic financial instrument are met, consideration will need to be given to the terms of the arrangements and the potential for variability of return from the financial asset. As a first stage, variables connected to the provision of ongoing services, including routine and lifecycle maintenance and facilities management, will need to be excluded from the assessment as they do not affect the return on the financial asset itself. It is also worth noting that the financial asset recognised reflects the fair value of the construction services provided and so is equivalent to a trade receivable for the construction services. The receipts supporting the financial asset will still be subject to some level of performance criteria, i.e. the availability of the infrastructure itself, although when it is probable that the infrastructure will be available, the financial asset would be classified as a basic financial instrument. This rationale is consistent with that applied to trade receivables that have a remaining performance condition attached but would still be classified as a basic financial instrument.

### Accounting by grantors

34C.18 For arrangements that are considered within the scope of this guidance, the grantor controls the infrastructure asset and, as such, will recognise the infrastructure as an asset (either as PP&E or as an intangible asset) together with a liability for its obligation under the service concession arrangement (reflecting the provision of the infrastructure asset). [FRS102.34.12E]

34C.19 Under this guidance the grantor uses a finance lease liability model to recognise the asset and associated liability. The asset and liability will be equal to the present value of the minimum lease payments for the infrastructure asset.

34C.20 The total payments made under the service concession arrangement should first be split between those relating to the infrastructure asset and those relating to operational services. In our view, this allocation should be completed for operators on a relative fair value basis, as is the case under IFRIC 12. Amounts payable to the operator in respect of operational services and maintenance are recognised only once those services have been provided. With respect to the infrastructure asset, the asset and liability will equal the present value of the allocated unconditional payments required to be made to the operator under the service concession arrangement. [FRS102.34.12F] No asset or liability is recognised for contingent payments to the operator, including scenarios when the payments are based on the level of usage of the infrastructure.

34C.21 Subsequently, the liability is accounted for in accordance with finance lease liability guidance under Section 20 and the asset is accounted for as PP&E or an intangible asset in accordance with Sections 17 and 18 respectively. [FRS102.34.12G-H] Contingent payments relating to the infrastructure are expensed as incurred.

### Transition

34C.22 From the operator's perspective, when service concession arrangements were entered into before the date of transition (i.e. the arrangement had reached legal completion of the terms of the arrangement/financial close) then the operator is not required to apply paragraphs 34.12I to 34.16A of FRS 102 to those service concessions. Instead, the operator continues to account for the arrangement using the same accounting policies as were applied at the date of transition to FRS 102. [FRS102.35.10(i)]

34C.23 When the transitional relief is utilised, previous accounting policies are applied to the classification of, and subsequent accounting for, the asset arising and the service concession arrangement itself. The transitional relief does not extend to other elements of the entity's accounting, such as its financing or taxation arrangements.

34C.24 No similar transitional relief is available for grantors.

## vs previous UK GAAP

### Applicable standards: FRS 5 Application note F

pUK34C.1 Previous UK GAAP concentrated on providing guidance on accounting for Private Finance Initiative (PFI) arrangements using a risks and rewards approach. Under IFRS and FRS 102 a 'grantor control' scope criterion applies.

pUK34C.2 If the arrangements are considered to be PFI arrangements, under Application note F of FRS 5, an entity considers initially whether the arrangement is akin to a lease and accounted for under the requirements of SSAP 21, or whether it is accounted for directly under FRS 5 Application Note F. If it is accounted for under FRS 5, the analysis, which determines the accounting, considers who has access to the benefits and exposure to the associated risks of the property and, as a result, who should recognise the property as a fixed asset. This analysis includes an assessment of various risks including: demand risk, residual value risk, under-performance penalties, and other risks. The combined effect of these risks is considered, with greater weight being given to those more likely to occur in practice, and those more likely to have the bigger impact. Typically, demand risk and residual value risk would have the biggest impact. If it is concluded that the operator has the risks and rewards, then the operator recognises a fixed asset at cost and then depreciates it: if not, the operator recognises a financial asset for the fair value of the property. When the purchaser/grantor applies this guidance, they would recognise a fixed asset and an obligation if it was concluded that they bear the risks and rewards of the property. It was, however, the case that many purchasers followed specific government accounting regimes that applied different criteria when accounting for PFI arrangements. FRS 102 takes a different approach to scoping and the nature of the asset recognised as a result of the application of the guidance.

## vs EU-IFRS

### Applicable standards: SIC-29, IFRIC 12

IFRS34C.1 IFRIC 12 includes more detailed guidance and requirements specific to service concession arrangements compared with FRS 102.

IFRS34C.2 IFRIC 12 applies directly to public-to-private service concession arrangements although it does not define 'public sector' or 'private sector'. Consequently, a wider variety of arrangements could fall within the scope of IFRIC 12 if the other scope requirements are met, including the requirement for a public service obligation to be present. Under FRS 102, the grantor is defined as a public sector body or a public benefit entity, and the operator is defined as a private sector entity.

IFRS34C.3 IFRIC 12 specifies that the operator shall account for revenue and costs relating to construction or upgrade services in accordance with IAS 11. No similar guidance is provided under FRS 102 as to whether revenue should be recognised for the construction or upgrade services provided. Instead, it indicates that the financial asset or intangible asset recognised will be measured initially at fair value, with fair value being based on the fair value of the construction (or upgrade) services provided.

IFRS34C.4 IFRIC 12 deals only with the accounting by operators and not grantors. A grantor would need to consider how to apply the general principles of IFRSs to the specific contractual arrangement it had with the operator.

## Financial institutions

### Overview

34D.1 The definition of a financial institution for the purpose of Section 34 is consistent with that of FRS 101 and FRS 102. Refer to paragraph 1.36 of this publication for a definition of 'financial institution' and our guidance on applying that definition in practice.

34D.2 Section 11 *Basic financial instruments* and Section 12 *Other financial instruments issues* include certain disclosure requirements for financial instruments that apply to all entities, regardless of their activities. However, whilst qualifying group entities, as defined in paragraph 1.24 of this publication, generally benefit from disclosure exemptions in respect of Sections 11 and 12 disclosures, these exemptions are not available to qualifying entities that are financial institutions. See also paragraph 3.8 of this publication.

34D.3 In addition to the disclosure requirements in Sections 11 and 12, a financial institution that is not a retirement benefit plan must provide the additional disclosures listed in the remainder of Chapter 34D. For retirement benefit plans see paragraph 34.E.13 of this publication. [FRS102.34.17(a), FRS102.34.18]

### Consolidated financial statements

34D.4 If a group contains a financial institution that is not a retirement benefit plan and financial instruments held by the financial institution are material at group level, then the consolidated financial statements need to provide the disclosures listed in paragraphs 34.D.5 to 34.D.22, but only in respect of financial instruments held by those group entities that are financial institutions. The principal activity of the group does not affect this disclosure requirement. [FRS102.34.17(b)]

### Disclosures about financial instruments

34D.5 A financial institution (other than a retirement benefit plan) is required to provide the detailed disclosures discussed in paragraphs 34D.6 to 34D.22 of this publication.

#### Significance of financial instruments

34D.6 The financial institution shall provide an explanation of the significance of financial instruments to the entity's financial statements, including a disaggregation of the relevant balance sheet captions by class of financial instrument, so as to display the nature and characteristics of those financial instruments. [FRS102.34.19]

34D.7 Section 34.D defines 'class of financial instrument' as 'a grouping of financial instruments that is appropriate to the nature of the information disclosed and that takes into account the characteristics of those financial instruments.' In our view, a financial institution should apply judgement in determining the level of detail provided. In doing so, the entity should aim to strike a balance between providing excessive detail that risks cluttering the financial statements, and aggregating the information to such a degree that useful information might be obscured.

#### Impairment allowance account

34D.8 To the extent that the financial institution uses any separate impairment allowance accounts, it shall provide a reconciliation of these impairment allowance accounts by class of financial asset. [FRS102.34.21]

#### Fair value

34D.9 A financial institution shall provide an analysis of financial instruments carried at fair value, classified into the three levels of the fair value hierarchy (see paragraph 11.91 of this publication). This information is provided by class of financial instrument measured at fair value. [FRS102.34.22]

### Nature and extent of risks arising from financial instruments

34D.10 A financial institution shall provide disclosures about the credit risk, liquidity risk and market risk that the entity is exposed to at the end of the reporting period. This includes, for each type of financial risk, an explanation of:

- how the risks arise;
- how the entity manages and measures the risks;
- any changes in how the risks arise, or in their management and measurement methods from the previous period.

[FRS102.34.23]



34D.11 Depending on the complexity of the financial institution's operations, we envisage that these disclosures could include, for example, a description of the risk management framework (e.g. departments with delegated responsibility such as a separate risk management function); policies for setting and monitoring limits for each type of financial risk; policies for hedging, taking collateral and other risk mitigating activities; and policies for measuring the risk (e.g. value-at-risk (VaR) models, sensitivity analysis, stress testing, etc).

#### Credit risk disclosures

34D.12 A financial institution shall disclose for each class of financial instrument: [FRS102.34.25-27]

- its maximum exposure to credit risk (to the extent that this differs from the carrying amount of the financial instrument);
- description of collateral, credit derivatives and other credit enhancements held and the extent to which they mitigate credit risk;
- information about the credit quality of financial assets that are neither past due nor impaired (for example, an analysis by external or internal credit rating or by nature of the counterparty);
- a maturity analysis of financial assets that are past due but not impaired (in our view, the financial institution should use judgement in determining the number of time bands disclosed);
- an analysis of financial assets that are individually considered to be impaired and the factors considered in the impairment assessment. This may include, for example, the gross amount receivable, any related impairment losses and the nature and/or fair value of collateral and other credit enhancements held;
- for any assets recognised as a result of an entity taking possession of collateral (e.g. a property) or calling on other credit enhancements (e.g. a financial guarantee contract), the nature and carrying amount of these assets and how the entity plans to dispose of or use any assets not readily convertible into cash.

#### Liquidity risk disclosures

34D.13 'Liquidity risk' is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. [FRS102.GL]

34D.14 A financial institution shall disclose a maturity analysis for financial liabilities showing the remaining contractual undiscounted amounts for both derivative and non-derivative financial liabilities. [FRS102.34.28]

34D.15 In our view, all contractual cash flows (i.e. both the interest and principal cash flows) should be included in the maturity analysis as this is more representative of the overall liquidity risk that the financial institution is exposed to.

34D.16 In our view, when the counterparty can choose when an amount is paid (e.g. demand deposits), the liability should be included on the basis of the earliest date on which the financial institution could be required to pay.

34D.17 Section 34 does not mandate the number of time bands that should be used. The financial institution should therefore use its judgement to determine an appropriate number of time bands.

#### Sensitivity analysis

34D.18 FRS 102 defines market risk as 'the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices' and distinguishes between three types of market risk: currency risk, interest rate risk and other price risk. [FRS102.GL]

34D.19 A financial institution shall provide a sensitivity analysis for each type of market risk that shows the effect on profit or loss and equity. Whilst Section 34 does not prescribe a particular methodology or format for the sensitivity analysis, it does require disclosure of the methods and the assumptions used in making this analysis. [FRS102.34.29]

34D.20 Some financial institutions use an internal risk management model that reflects interdependencies between risk variables, e.g. a VaR approach. In such cases, the entity may provide disclosures based on that internal risk management model rather than the sensitivity analysis described in paragraph 34D.19 above. [FRS102.34.30]



### Disclosures about capital

34D.21 The financial institution shall disclose its objectives, policies and processes for managing capital, based on the information provided internally to key management personnel. This includes qualitative and quantitative data about what the entity manages as capital, as well as information about externally imposed capital requirements. [FRS102.34.31]

34D.22 If giving these disclosures on an aggregate basis would not provide useful information due to the different capital requirements across the entity, then separate information is provided. [FRS102.34.32]

### Reporting cash flows on a net basis

34D.23 As explained in paragraph 7.7 of this publication, major classes of gross cash receipts and payments arising from investing and financing activities are generally required to be presented separately in the cash flow statement, unless there is a specific exemption from 'gross presentation'. [FRS102.7.10]

34D.24 Section 34 permits financial institutions that are required to present a cash flow statement to include the following cash flows on a net basis:

- cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;
- the placement of deposits with, and withdrawal of deposits from, other financial institutions; and
- cash advances and loans made to customers and the repayment of those advances and loans. [FRS102.34.33]

### Transition

34D.25 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

**vs previous UK GAAP – FRS 26 adopters****Applicable standards: FRS 1, FRS 26, FRS 29**

pUK34D.1 If an entity had adopted FRS 26 and hence applied FRS 29, the disclosure requirements for financial instruments and capital were the same as under IFRS - see the 'vs EU-IFRS' section. However, FRS 26 provides a disclosure scope exemption for subsidiary undertakings (other than banks or insurance companies) for which 90 percent or more of the voting rights were controlled within the group, and which were included in publicly available consolidated financial statements that included the disclosures required by FRS 26. There is no similar exemption in FRS 102. FRS 26 and associated standards were mandatory for entities listed on an EU-regulated market and those applying the fair value accounting rules of the Companies Act.

**vs previous UK GAAP – non-FRS 26 adopters****Applicable standards: FRS 1, FRS 13**

pUK34D.2 Many (but not all) of the financial institutions defined by FRS 102 that did not previously adopt FRS 26 would have been required to provide the disclosures of FRS 13 Part B (banks and similar institutions) or Part C (financial institutions other than banks). The disclosures required by FRS 13 Parts B and C differ from FRS 102 in a number of respects, e.g. FRS 13 required more detailed analysis of interest rate and currency risk exposure but had no specific disclosure requirements in respect of credit risk.

pUK34D.3 If the entity had not adopted FRS 26, it would not be required to make the capital disclosures outlined in FRS 29, although the Companies Act would still require certain disclosures.

**vs EU-IFRS****Applicable standards: IAS 1, IAS 7, IFRS 7, IFRS 13**

IFRS34D.1 Equivalent requirements are included in IAS 1 for capital disclosures, IAS 7 for reporting of cash flows on a net basis, IFRS 13 for the fair value hierarchy and IFRS 7 for the remainder of the financial instruments disclosures. The main difference is that IFRS 7 and IFRS 13 have more extensive disclosure requirements including, for example, details of reclassification of financial instruments between categories, summary quantitative data about risk exposures based on internal information provided to senior management, more detailed credit risk disclosures, more extensive fair value measurement disclosures and details of any transfers of financial assets.

## Retirement benefit plans: Financial statements

34E.1 Retirement benefit plans include defined contribution (DC) plans, defined benefit (DB) plans and plans with both DC and DB elements. When a plan has both DC and DB sections, it differentiates between these in its financial statements (if material). [FRS102.34.34]

34E.2 A DC plan is a post-employment benefit plan under which an entity pays fixed contributions into a separate entity (a fund) and has no legal or constructive obligation to pay further contributions, or to make direct benefit payments to employees if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. DB plans are all retirement benefit plans that are not DC plans. [FRS102.GL]

34E.3 A retirement benefit plan does not need to comply with the FRS 102 definition of a complete set of financial statements (see paragraph 3.66 of this publication). [FRS102.34.35] It is exempt from Section 7 *Statement of cash flows* and so does not present a cash flow statement. [FRS102.7.1A] A retirement benefit plan refers to the Pensions SORP (updated in November 2014 to reflect FRS 102) for further guidance.

34E.4 The financial statements of retirement benefit plans include:

- a fund account that presents changes in net assets available for benefits, including fair value changes;
- a net assets statement that presents net assets available for benefits; and
- notes that contain significant accounting policies and explanatory information. [FRS102.34.35]

34E.5 The fund account of a DB or DC plan presents:

- employer contributions;
- employee contributions;
- investment income such as interest and dividends;
- other income;
- benefits paid or payable (analysed, for example, as retirement, death and disability benefits, and lump sum payments);
- administrative expenses;
- other expenses;
- taxes on income;
- profits and losses on disposal of investments and changes in value of investments; and
- transfers from and to other plans. [FRS102.34.37]

34E.6 The net assets statement of a DB or DC plan presents its net assets available for benefits, being its:

- assets at the period end classified appropriately; less
- liabilities at the period end excluding the actuarial value of future retirement benefits.

34E.7 The approach to valuing the plan's assets is explained in the notes. [FRS102.34.38]

34E.8 The net assets available for benefits are measured at fair value, which is determined in accordance with Section 11 *Basic financial instruments* (see paragraph 11.90 of this publication). However, the fair value of certain insurance policies is established as set out in the following paragraph (see also paragraph 28.28 of this publication). [FRS102.28.15, FRS102.34.36]

34E.9 When the asset is an insurance policy that exactly matches both the amount and timing of some or all of the benefits payable by the plan, the fair value of the asset is deemed to be the present value of the related benefit liability, even though the liability itself will not be recognised in the financial statements (see paragraph 34E.14 of this publication). [FRS102.34.36]

34E.10 No exception is made from the requirement to carry plan assets at fair value for investments in any subsidiaries, associates or joint ventures. A retirement benefit plan is not required by FRS 102 (nor, for UK plans, by the law) to prepare consolidated financial statements and will therefore include any such investments at fair value in its individual financial statements (see also paragraph 34E.16 of this publication).

34E.11 When a plan holds assets at fair value that are not financial instruments, it follows the disclosure requirements of the relevant section of FRS 102, e.g. for investment properties, as set out in FRS 102.16.10. [FRS102.34.39]

34E.12 A retirement benefit plan is classified as a financial institution but does not give all the disclosures required by FRS 102.34.19 to FRS 102.34.33 (see Chapter 34D of this publication). [FRS102.34.17]

34E.13 The disclosures required for a retirement benefit plan are listed in both FRS 102.11.39-48A and FRS 102.34.39-48 and include:

- financial instruments are disaggregated by class for the purpose of disclosure to enable users to evaluate the performance and position of the financial instruments;
- when financial instruments are held at fair value, their hierarchy is disclosed (see paragraph 11.91 of this publication); and
- the nature and extent of credit risk and market risk.

34E.14 There is no requirement for a DB plan to recognise an actuarial liability for future retirement benefits. [FRS102.34.47] Instead, it presents an additional report attached to the financial statements showing:

- the actuarial present value of future retirement benefits as per the latest plan valuation;
- the date of the latest plan valuation; and
- the method and significant assumptions used by the actuary in that valuation. [FRS102.34.48]

34E.15 The Pensions SORP provides supplementary guidance on how to apply the FRS 102 requirements as well as limited additional disclosures for financial statements prepared under FRS 102.

34E.16 In addition to both FRS 102 and the Pensions SORP there are legal requirements, such as the Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 and the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013, that continue to apply to the preparation of, and disclosures within, financial statements of UK retirement benefit plans.

## Transition

34E.17 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

## vs previous UK GAAP

### Applicable standard: Pensions SORP (May 2007)

pUK34E.1 Financial statements of retirement benefit plans prepared under previous UK GAAP apply the Financial reports of pension schemes SORP (May 2007) (May 2007 Pensions SORP).

pUK34E.2 Under the May 2007 Pensions SORP there is an option, for certain insurance policy assets, to hold these assets at nil.

pUK34E.3 Under the May 2007 Pensions SORP only investment assets (and not operating assets or liabilities) are held at fair value.

pUK34E.4 Previous UK GAAP requires consolidated accounts to be prepared if the plan has subsidiaries.

pUK34E.5 FRS 102 requires more disclosures than the May 2007 Pensions SORP, particularly for financial instruments.

## vs EU-IFRS

### Applicable standard: IAS 26

IFRS34E.1 IAS 26 permits actuarial liabilities to be either:

- recognised in the net assets statement;
- disclosed in the notes to the financial statements; or
- disclosed in a separate report alongside the financial statements (as in FRS 102).

IFRS34E.2 Under IAS 26 only investment assets, financial and non-financial, are held at fair value. Other assets and liabilities are accounted for under the relevant IFRS.

IFRS34E.3 There are no disclosure exemptions available from IFRS 7.

## Heritage assets

34F.1 Heritage assets are tangible and intangible assets with historic, artistic, scientific, technological, geophysical, or environmental qualities held and maintained principally for their contribution to knowledge and culture. [FRS102.GL]

34F.2 When historic assets or works of art are not maintained principally for their contribution to knowledge and culture, they are not heritage assets and either Section 16 *Investment property*, Section 17 *Property, plant and equipment* or Section 18 *Intangible assets other than goodwill* applies as appropriate. For example, historic buildings used as offices, or works of art used as decoration, are not heritage assets. Nevertheless, entities may consider it appropriate to give the related heritage asset disclosures for such assets. [FRS102.34.49-50]

34F.3 An entity applies Section 17 in accounting for heritage assets, including its policy choice of the cost or revaluation models, except that:

- heritage assets are disclosed separately in the balance sheet from other assets; [FRS102.34.52]
- when information on the cost or value of an asset is not available, and cannot be obtained at a cost commensurate with the benefit to users of the financial statements, it is not recognised in the balance sheet but appropriate disclosures are instead included in the notes; and [FRS102.34.53]
- Section 27 *Impairment of assets* is applied at each balance sheet date to determine whether a heritage asset is impaired. [FRS102.34.54]

34F.4 An impairment of a heritage asset might arise if, for example, the asset has become physically damaged or doubts arise as to its authenticity. [FRS102.34.54]

34F.5 Intangible heritage assets are less likely to arise in practice than tangible heritage assets. Interestingly, Section 34 seems to require the recognition and measurement rules of Section 17, rather than of Section 18, to be applied to intangible heritage assets. This would seem to avoid the prohibition in Section 18 on revaluing intangible assets for which there is no active market. However, the revaluation model in Section 17 requires any fair value to be measurable reliably; for intangible heritage assets in particular, this may be a high hurdle to overcome.

34F.6 FRS 102.34.55 - 56 list the disclosure requirements for those heritage assets that are recognised in the balance sheet and for those that are not. Such disclosures include information on the nature and scale of heritage assets held by the entity, as well as a reconciliation of the carrying amount and a summary of the acquisitions, donations and disposals of heritage assets for the current period and previous four periods. When information on cost or value of an asset is not available an explanation of the reason is disclosed.

## Transition

34F.7 Transition exemptions are available for items of property, plant and equipment, investment property and certain intangible assets on first-time adoption of FRS 102, e.g. the option to measure the asset at fair value or at a previous-GAAP revalued amount on transition. The same exemptions could be applied to heritage assets (see Chapter 35 of this publication).

## vs previous UK GAAP

### Applicable standard: FRS 30

pUK34F.1 The definition of a heritage asset under FRS 102 includes intangible assets. Under FRS 30 the definition is restricted to tangible assets.

pUK34F.2 Heritage assets generally are accounted for in the same way under FRS 102 and FRS 30, although differences can arise in relation to the recognition of revaluation losses (see Chapter 17 of this publication).

pUK34F.3 Under FRS 30 donated heritage assets are recognised initially at valuation unless (exceptionally) it is not practicable to do so. This is not specifically covered in Section 34 but under paragraph FRS 102.17.14, an asset acquired in an exchange transaction is measured at fair value and FRS 102.PBE34.73 requires that a donated asset is recognised at fair value. However, the use of fair value under FRS 102 may not always be consistent with the approach under FRS 30 as FRS 30 does not require fair value to be used and permits the use of any appropriate and relevant valuation method.

## vs EU-IFRS

### Applicable standards: IAS 16, IAS 38, IAS 40

IFRS34F.1 There is no concept of heritage assets under IFRS. Such assets would be accounted for under IAS 16, IAS 38 or IAS 40.

## Funding commitments

34G.1 A funding commitment is a commitment to provide resources to another entity in a non-exchange transaction. [FRS102.34.57; FRS 102.ACA.149] A non-exchange transaction is a transaction whereby an entity gives value to another entity without directly receiving approximately equal value in exchange. [FRS102.GL]

34G.2 Commitments to fund another party by making a loan to that party are not in the scope of this section and are covered by Section 11 *Basic financial instruments* or Section 12 *Other financial instruments issues*. [FRS102.34.57] This section deals, for example, with commitments to give grants or similar financial support to or by a charity. Its application is, however, wider than just public benefit entities.

34G.3 Entities often make commitments to provide funding to other entities. An entity recognises a liability and, usually, the related expense for a commitment to fund (other than with loans) another party when:

- the definition and recognition criteria for a liability are met (see paragraph 3.32 of this publication);
- the entity cannot reasonably withdraw from the obligation (which could be either legal or constructive); and
- there are no performance conditions to be satisfied before the other party is entitled to the funding. [FRS102.34.59]

34G.4 The expectation of funding another entity is not sufficient for liability recognition, e.g. a general statement that funding will be given to a certain class of beneficiaries. For a liability to be recognised the grantor will have raised a valid expectation in the recipient from which it cannot realistically withdraw, i.e. it will have communicated details of the funding to the recipient. A liability is not recognised when the promise to fund is conditional on the receipt of funds from another party and it is probable that the economic benefits will not be transferred. [FRS102.34A.2,A.3]

34G.5 When there are performance conditions, the liability is recognised only once these are met. [FRS102.34.60,34 A.4] A performance condition is a condition that requires the performance of a particular level of service or units of output to be delivered, with payment of, or entitlement to, the resources conditional on that performance. [FRS102.GL] For example, an entity makes a grant of £10,000 per year for the next three years to a charity, on the condition that each year the funds are used to assist a specific number of beneficiaries identified by the entity and the charity prepares a detailed report of how this target was met. The entity does not recognise a liability for the second and third years' grant until the charity has demonstrated that it has met these specific performance conditions for the previous year's grant. If a condition is merely administrative (e.g. submission of the annual financial report, the non-submission of which would not release the grantor from its commitment) then this is not a performance condition. [FRS102.34A.5]

34G.6 The liability is recognised at the present value of the committed resources. [FRS102.34.61] When a liability is not recognised for a funding commitment, disclosure of the details of this commitment are made. [FRS102.34A.6]

34G.7 Appendix A to Section 34, which is an integral part of the standard, provides further guidance on funding commitments.

34G.8 Letters of support (or parental guarantees) are often given by parent companies to indicate their intention to continue to provide general financial support to a subsidiary. In our view, these do not fall within the scope of Section 34 since they do not constitute commitments to provide resources to other entities in a non-exchange transaction. Such arrangements are within the scope of Section 21 *Provisions and contingencies*.

34G.9 Funding commitments are also covered in the Charities SORP and the FEHE SORP. The latter gives bursaries and scholarships paid to students as examples of funding commitments that should be recognised when the student is entitled to the payment, e.g. if students are required to meet academic targets at the end of each year of study then a liability for the bursaries and scholarships for the subsequent period will be recognised only when those conditions are met.

## Transition

34G.10 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.



### vs previous UK GAAP

Applicable standards: FRS 12, Charities SORP (2008), Housing SORP (2012), FEHE SORP (2007)

pUK34G.1 There is no specific guidance on funding commitments in the accounting standards, Housing SORP (2012) or FEHE SORP (2007) under previous UK GAAP. Commitments would be accounted for when they meet the definition of a liability under FRS 12.

pUK34G.2 The Charities SORP (2008) includes specific guidance on funding commitments, similar to that provided by FRS 102.

### vs EU-IFRS

Applicable standard: IAS 37

IFRS34G.1 There is no specific guidance on funding commitments under IFRS. Commitments would be accounted for when they meet the definition of a liability.

## Public benefit entities: Scope

34H.1 A public benefit entity (PBE) is an entity whose primary objective is to provide goods or services for the general public, community or social benefit and for which any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members. A PBE group includes a PBE parent and all of its wholly-owned subsidiaries. [FRS102.GL]

34H.2 A PBE may benefit a particular section of the public rather than society as a whole; however, its primary purpose is not to bring a return to its investors. Mutual insurance companies and co-operatives that pay dividends are therefore not PBEs. Equity investors in PBEs have contributed to the entity to support the provision of goods or services to beneficiaries and not for financial return. [FRS102.GL]

34H.3 Paragraphs in FRS 102 prefixed by 'PBE' apply solely to public benefit entities. These paragraphs are not applicable (whether directly or by analogy) to entities that are not PBEs. [FRS102.1.2] Most are in Section 34 but a small number, and certain other specific references to PBEs, appear elsewhere as follows:

- Section 11 *Basic financial instruments* [FRS102.PBE11.1A] and Section 12 *Other financial instruments issues* [FRS102.PBE12.1A] refer users to Section 34 for details of how to account for concessionary loans (see Chapter 34K of this publication).
- Section 13 *Inventories* [FRS102.13.5A] requires inventory acquired by PBEs through non-exchange transactions to be recognised initially at fair value only when it is practicable to recognise incoming resources (see paragraph 34I.6 of this publication).
- Section 16 *Investment property* [FRS102.16.3A] requires property held for the provision of social benefit to be accounted for as property, plant and equipment and not as investment property (see Chapter 17 of this publication).
- Section 19 *Business combinations and goodwill* [FRS102.PBE19.2A] refers users to Section 34 for the accounting for PBE combinations (see Chapter 34J of this publication).

34H.4 Other than as directed by the paragraphs listed above, all other requirements of FRS 102 are applicable to PBEs. This includes requirements on funding commitments (see Chapter 34G of this publication).

34H.5 Early-adoption of FRS 102 is permitted only if there is no conflict with any relevant SORP. This requirement is particularly relevant to PBEs as many apply the Charities SORP (July 2014), FEHE SORP (March 2014) or Housing SORP (September 2014). [FRS102.1.14]

34H.6 The financial statements of a PBE that applies 'PBE' paragraphs include an explicit statement that the entity is a public benefit entity. [FRS102.PBE3.3A]

## Transition

34H.7 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

### vs previous UK GAAP

Applicable standards: Charities SORP (2008), FEHE SORP (2007), Housing SORP (2012)

pUK34H.1 There is no general concept of PBEs under previous UK GAAP. Similarly to FRS 102, if an entity is within the scope of a SORP then it applies that SORP.

### vs EU-IFRS

Applicable standard: IAS 37

IFRS34H.1 There is no general concept of PBEs under IFRS. EU-IFRSs apply equally to PBEs.

## Public benefit entities: Incoming resources from non-exchange transactions

34I.1 A non-exchange transaction is a transaction whereby an entity receives value from (or gives value to) another entity without directly giving (or receiving) approximately equal value in exchange. [FRS102.PBE34.65]

34I.2 Examples of non-exchange transactions are donations (of cash, goods and services) and legacies. [FRS102.PBE34.66] The accounting for government grants, which are similar in many ways, is covered by Section 24 *Government grants*. [FRS102.PBE34.64] Government grants may be accounted for either under a performance model or an accrual model but only the former is available for other non-exchange transactions for PBEs.

34I.3 When they can be measured reliably, receipts of resources from non-exchange transactions by PBEs or entities in PBE groups are recognised at fair value:

- in income when received or receivable, when there are no future performance conditions;
- in income when performance conditions are met; or
- as a liability (most likely as deferred income) when resources are received before the revenue recognition criteria are met. [FRS102.PBE34.67]

34I.4 For example, for income from legacies, the recognition criteria are normally met following probate. If notification of the legacy payment is received post-year-end but the executors had agreed pre-year-end that there are sufficient estate funds to pay the legacy, then the legacy is accrued in the financial statements. PBEs with many immaterial legacies may take a portfolio approach. [FRS102.PBE34B.5-7]

34I.5 When there are no performance conditions, income is recognised immediately rather than being spread over any expected period of benefit, i.e. there is no 'accrual' model.

34I.6 If it is impracticable to estimate the value of resources received or receivable sufficiently reliably (or the costs of valuation outweigh the benefits), then income is recognised when the resources are sold. [FRS102.PBE34.69-70] For example, high volume, low value second-hand goods donated for resale are recognised as income in the period in which they are sold. [FRS102.PBE34B.4] [FRC SEN12 Example 1]

34I.7 Donations of services that can be reasonably quantified (e.g. services that would otherwise have been purchased, such as legal services) are recognised as both income and expense, or capitalised when the services are used in the production of an asset. [FRS102.PBE34.72, FRS102.PBE34B.8-9] [FRC SEN12 Example 3] However, the standard expects that volunteer services cannot be reasonably quantified and such services are not recognised. It appears, therefore, that there is no option to recognise volunteer services as income and expense; the benefit is instead disclosed in the financial statements. [FRS102.PBE34B.11-12] [FRC SEN12 Example 2]

34I.8 Income from non-exchange transactions is measured on one of the two following bases, as appropriate:

- The value to the entity for donated services or facilities that would otherwise have been purchased. The value to the entity is the estimated price payable in the open market for a service or facility of equivalent utility to the entity. For example, an entity receives pro bono legal services from an internationally renowned law firm but would otherwise have engaged a local law firm. The income and expense is measured by reference to the cost the entity would have incurred had it engaged the local firm.
- Fair value of the resources received (usually open market value), for all other income from non-exchange transactions, i.e. donations other than services or facilities, or of services or facilities that the PBE would not otherwise have purchased. For example, a new donated motor vehicle is valued at the open market value of that asset rather than at the market value of a second-hand vehicle that might otherwise have been adequate for the PBE's purposes. In many such cases the PBE could sell the donated asset and, if appropriate, purchase a cheaper replacement asset with the equivalent service potential. [FRS102.PBE34.73, FRS102.PBE34B.15-16, FRS 102.ACA154-155]

34I.9 When open market value cannot be determined, other sources such as cost to the donor or estimated resale value less costs to sell may be used to calculate a value. [FRS102.PBE34B.17]

34I.10 Non-exchange transactions may include a number of conditions or requirements but it is only those meeting the definition of performance conditions that may require deferral of recognition of the incoming resource as income.

34I.11 A performance condition is a condition that requires the performance of a particular level of service or units of output to be delivered, with payment of, or entitlement to, the resources conditional on that performance. [FRS102.GL]

#### Example 34I.1

PBE X receives a donation on condition that it is spent on purchasing a specific piece of equipment that is available for use by the PBE's beneficiaries. The donor makes the donation in advance of the order being placed for the equipment.

The PBE's year-end falls between the order being placed for the equipment and its delivery. At the year end the PBE does not recognise the donation as income; it has not yet fulfilled the performance conditions attached to the donation, which require the purchase of the equipment and for it to be made available for use by beneficiaries. Instead, it recognises a liability for the full amount of the donation and discloses the unfulfilled performance conditions attached to the donation.

During the following year, after the equipment has been received and made available for use, the PBE derecognises the liability and recognises the donation as income in full. The equipment is recognised as an item of property, plant and equipment and is depreciated over its estimated useful life. [FRS SEN12 Example 4]

34I.12 Judgement may be required in establishing whether conditions are fulfilled over a period of time or at a point in time. Appendix B to Section 34 acknowledges that some requirements are stated so broadly that they do not actually impose a performance condition, in which case income is recognised on receipt of the resources. [FRS102.PBE34B.14] An example of such a requirement might be an obligation on a charity that receives a donation to supply a copy of its annual accounts when they are available.

34I.13 When repayment of a resource that has previously been recognised as income becomes probable due to non-compliance with performance conditions, the standard requires that an entity recognises a liability. [FRS102.PBE34.71] Given the requirement to have met any performance conditions prior to recognising the related income (see paragraph 34I.3 above), this is not expected to be common. This may, however, arise when what was previously considered to be a non-substantive performance condition is not met and the donor seeks to enforce the requirement, for example, if the charity in the above case did not supply a copy of its annual accounts and repayment is sought and deemed probable.

34I.14 The existence of a restriction does not prohibit a resource from being recognised in income when receivable. [FRS102.PBE34.68] A restriction limits or directs the purposes for which a resource may be used but the requirement does not meet the definition of a performance condition (e.g. a donated asset that may be used only to provide services for a particular category of beneficiary). [FRS102.GL] If repayment becomes probable as a result of a breach of a restriction, then a liability is recognised. [FRS102.PBE34.71]

34I.15 Modules 5 and 6 of the Charities SORP provide guidance on accounting for income by charities, including non-exchange transactions. Section 18 of the FEHE SORP and Chapter 17 of the Housing SORP also provide guidance in this area.

#### Transition

34I.16 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

**vs previous UK GAAP****Applicable standards: FRS 5, Charities SORP (2008), FEHE SORP (2007), Housing SORP (2012)**

pUK341.1 Accounting standards contain no specific guidance on non-exchange transactions or donated goods and FRS 5 would apply. The pre-FRS 102 PBE SORPs include guidance as follows.

pUK341.2 The Charities SORP (2008) includes accounting requirements for donations of cash, goods and services and legacies. Incoming resources are recognised when entitlement, certainty and measurement criteria are met. Gifts in kind are recognised at their value to the charity.

pUK341.3 Under the FEHE SORP (2007), charitable donations are recognised when received or before receipt if it is sufficiently certain the donation will be received and the value can be measured reliably. If donations are for restricted purposes they are recognised on the balance sheet as endowment funds. If the donation is for the purchase or construction of a fixed asset, it is recognised as a deferred capital grant. When performance conditions are fulfilled over time, an accruals method of recognition is adopted.

pUK341.4 Under the Housing SORP (2012) a gift is measured at current value and recognised in turnover when the donation is from a non-public body.

**vs EU-IFRS****Applicable standards: IAS 20, IFRIC 12, IFRIC 18**

IFRS341.1 There is no specific guidance under IFRS on assets or resources received by not-for-profit entities from third parties for no consideration. With the exception of assets or resources transferred to an entity by a government via government grant (IAS 20), or arrangements within the scope of IFRIC 12 or IFRIC 18, there is also no guidance on such receipts by other entities. Guidance on accounting for these arrangements by not-for-profit entities may be obtained from IAS 20. This provides a choice of accounting policy to measure the assets or resources either at their fair value or at the nominal amount paid, and to recognise them to reflect the existence of any related conditions.

## Public benefit entities: Entity combinations

34J.1 This section is applicable for public benefit entities when entity combinations:

- are at nil or close to nil and are, in substance, a gift and not a fair value exchange; or
- are a merger. [FRS102.PBE34.75]

34J.2 Other combinations that are not, in substance, a gift or do not meet the definition of a merger are accounted for in line with Section 19 *Business combinations and goodwill*. [FRS102.PBE34.76, FRS102.PBE34.81]

34J.3 Combinations that are, in substance, a gift are accounted for in line with Section 19 [FRS102.PBE34.77] except that:

- a gain is recognised in income for any excess of the fair value of the assets received over the fair value of the liabilities assumed; [FRS102.PBE34.78] and
- a loss is recognised in expenses for any excess of the fair value of the liabilities assumed over the fair value of the assets received. [FRS102.PBE34.79]

34J.4 This means that all identifiable assets and liabilities acquired are included at fair value but there will be no goodwill or negative goodwill.

34J.5 Combinations are a merger when a new reporting entity is created from the combining entities in which controlling parties of the combining entities come together in a partnership for the mutual sharing of risks and benefits of the newly-formed entity, and in which no party to the combination, in substance, obtains control over any other or is otherwise seen to be dominant. [FRS102.GL]

34J.6 Mergers are required to meet all of the following criteria in order to be accounted for using merger accounting:

- no party is depicted as the acquirer or acquiree by any party to the combination;
- the beneficiaries of the combining entities and the purpose of the benefits provided do not change significantly as a result of the combination; and
- all parties are involved in the development of the management structure of the new combined entity, which is based on consensus rather than voting rights. [FRS102.GL]

34J.7 Under merger accounting:

- there are no fair value adjustments to the carrying values of the entities' assets and liabilities; [FRS102.PBE34.82]
- adjustments are made to align accounting policies when these differ; [FRS102.PBE34.82]
- the results and cash flows of the merging entities are combined from the start of the financial period in which the merger occurred; [FRS102.PBE34.83]
- the comparatives are restated as 'combined' figures, incorporating the results for all merging entities for the previous accounting period; [FRS102.PBE34.84]
- any merger costs are charged to income and expenditure when they are incurred. [FRS102.PBE34.85]

34J.8 Module 27 of the Charities SORP provides guidance on accounting for charity mergers. Section 13 of the FEHE SORP and Chapter 9 of the Housing SORP provide guidance on business combinations generally, including mergers.

### Transition

34J.9 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication..

## vs previous UK GAAP

### Applicable standards: FRS 6, Charities SORP (2008), FEHE SORP (2007), Housing SORP (2012)

pUK34J.1 Under FRS 6, merger accounting is permitted providing certain conditions are met. These criteria include those of FRS 102 but also criteria on the form of consideration given, the relative sizes of the combining entities, and the retention of a material interest in the future performance of only part of the combined business.

pUK34J.2 There is no specific guidance under accounting standards on business combinations for nil consideration; the general requirements of FRS 6 would result in negative goodwill being recognised on the balance sheet. However, the PBE SORPs do include guidance in this area.

pUK34J.3 The Charities SORP (2008) states that merger accounting is applicable for charities when two or more charities merge. This applies despite two of the five criteria referring to shareholders' funds (and hence not being applicable for charities). Merger accounting also applies for business combinations with nil consideration (i.e. a gift), with the balancing credit/debit recognised as income/expense. Charities cannot merge with non-charitable companies; acquisition accounting would apply when such companies are acquired.

pUK34J.4 Under the FEHE SORP (2007), merger accounting is applied when the FRS 6 criteria (excluding the two relating to shareholders' funds) are met. When the criteria are not met, acquisition accounting is applied. Goodwill is recognised for the difference between consideration paid and net assets acquired. There is no guidance for business combinations with nil consideration.

pUK34J.5 Under the Housing SORP (2012), there are three applicable accounting treatments for business combinations involving two or more social landlords: merger accounting; acquisition accounting for commercial transactions; and accounting for non-exchange transactions, i.e. a form of acquisition accounting to be used when, in substance, one business has been gifted to another. It is expected that most business combinations failing to meet the FRS 6 criteria for merger accounting are accounted for as non-exchange transactions since there is rarely any purchase consideration. For non-exchange transactions, the fair value of the recognised assets and liabilities gifted is recognised as a gain or loss in the income and expenditure account in the year of the transaction.

## vs EU-IFRS

### Applicable standard: IFRS 3

IFRS34J.1 Under IFRS, common control transactions may be accounted for at book value. This is similar to merger accounting but there are differences, e.g. prior year comparatives are not required to be restated for the combined entities. Combinations between unrelated organisations are accounted for as acquisitions under IFRS 3.

IFRS34J.2 IFRS 3.43 states that when a business combination is achieved without the transfer of consideration, the acquisition method is applied. The acquirer uses the acquisition date fair value of its interest in the acquiree, determined using a valuation technique rather than the acquisition date fair value of the consideration transferred, to determine the amount of goodwill. Any gain on a bargain purchase is recognised in profit or loss.



## Public benefit entities: Concessionary loans

34K.1 This section is applicable for PBEs or entities within a PBE group with concessionary loan arrangements only: it does not apply to market-rate loans or other commercial arrangements. [FRS102.PBE34.87]

34K.2 Concessionary loans are those made or received between a PBE, or an entity within a PBE group, and a third party at below the prevailing market rate of interest that are not repayable on demand and are to further the objectives of the PBE or PBE parent. [FRS102.PBE34.88]

34K.3 'Entities within a PBE group' include all wholly-owned subsidiaries of a PBE parent and may not necessarily be PBEs themselves. [FRS102.GL] Such entities are able to take advantage of the alternative accounting for concessionary loans set out in this section.

34K.4 Concessionary loans made and received are accounted for either:

- initially at fair value and subsequently at amortised cost in accordance with Section 11 *Basic financial instruments*; [FRS102.PBE34.89] or
- initially at the amount paid or received [FRS102.PBE34.90] and subsequently adjusted for accrued interest payable or receivable. [FRS102.PBE34.91] Any irrecoverable element of a loan is recognised as an impairment in income and expenditure. [FRS102.PBE34.92]

34K.5 For example, PBEs have a choice as to whether to recognise an interest-free term loan, given to further the objectives of the PBE, initially at fair value or its face value. If the face value option is chosen, no interest is charged subsequently as the loan is interest free. This option allows the entity to recognise the loan and interest at the stated amount in the terms rather than at the effective interest rate, as would be required by Section 11. The chosen policy is applied consistently to all concessionary loans, both made and received. [FRS102.PBE34.89] Disclosure of concessionary loan details is required.

34K.6 Modules 11 and 21 of the Charities SORP provide guidance on accounting for financial assets and liabilities and social investment, including concessionary loans. Concessionary loans are covered in Section 26 of the FEHE SORP and Chapter 17 of the Housing SORP.

### Transition

34K.7 No exemption is available from retrospective application of the requirements of the standard on first-time adoption of FRS 102. Transition to FRS 102 is discussed in Chapter 35 of this publication.

vs previous UK GAAP – FRS 26 adopters  
Applicable standard: FRS 26

pUK34K.1 For entities applying FRS 26, see the 'vs EU-IFRS' section.

vs previous UK GAAP – non-FRS 26 adopters  
Applicable standard: FRS 4

pUK34K.2 Non-FRS 26 entities recognise loans at amortised cost. There is no specific guidance or requirements on concessionary loans under previous UK GAAP or in the PBE SORPs.

vs EU-IFRS  
Applicable standard: IAS 39

IFRS34K.1 Loans at below market rate are accounted for under the recognition and measurement criteria of IAS 39, i.e. initial measurement at fair value and subsequent measurement at amortised cost. Any immediate gain on recognition would be taken as income (in effect a donation). Loans repayable on demand will not have a fair value less than the face value of the loan. When a parent entity grants a loan at below market rate of interest to its subsidiary, the benefit is accounted for as a capital contribution and recognised in equity.



# 35 Transition to FRS 102

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## OVERVIEW OF REQUIREMENTS

- This section details the transitional requirements and exemptions available for the first FRS 102 financial statements that a first-time adopter prepares.
  - The date of transition is the first day of the earliest comparative period for which the entity presents its financial statements under FRS 102.
  - FRS 102 is applied retrospectively except for derecognition of financial assets and liabilities, accounting estimates, discontinued operations and measuring non-controlling interests.
  - There are first-time adoption exemptions available, including for business combinations, dormant companies and the deemed cost of revalued assets.
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## FRS 102

### Section 35

35.1 This section applies to the first financial statements of a first-time adopter of FRS 102, regardless of its previous accounting framework. [FRS102.35.1]

35.2 The first financial statements under FRS 102 are the first financial statements including an explicit and unreserved statement of compliance with FRS 102, when previous financial statements were not prepared under FRS 102, e.g. those financial statements were prepared in accordance with previous UK GAAP, FRS 101 or EU-IFRS. [FRS102.35.4]

35.3 The date of transition to FRS 102 is the beginning of the earliest period for which the entity presents full comparative information in accordance with FRS 102 in its first set of FRS 102 financial statements. For example, if an entity's first financial statements prepared under FRS 102 are for the year ended 31 December 2015, with comparatives shown under FRS 102 for the year ended 31 December 2014, then the entity's date of transition to FRS 102 is 1 January 2014. [FRS102.35.6]

35.4 When an entity has previously applied FRS 102 but did not include an explicit and unreserved statement of compliance with FRS 102 in its most recent previous financial statements, the entity either:

- applies this section; or
- applies FRS 102 retrospectively as if it had never stopped applying the standard. [FRS102.35.2]

35.5 On the date of transition to FRS 102, except as noted in paragraphs 35.10 to 35.41 of this publication, an entity:

- recognises and measures assets and liabilities in line with FRS 102;
- does not recognise assets or liabilities if not permitted by FRS 102; and
- reclassifies types of assets or liabilities or equity components to those required by FRS 102. [FRS102.35.7]

35.6 An opening balance sheet at the date of transition to FRS 102 is not required to be presented. [FRS102.35.7]

35.7 Adjustments to items as a result of transition to FRS 102 are recognised in retained earnings or another more appropriate category of equity (for example, a revaluation reserve if the fair value as deemed cost exemption is taken – see paragraph 35.21 below) at the date of transition. [FRS102.35.8]

35.8 FRS 102 includes a number of mandatory exceptions and optional exemptions from retrospective application of FRS 102 on first-time adoption as discussed below.

35.9 If it is impracticable to restate any assets or liabilities in accordance with the requirements of Section 35, an entity applies the requirements to the earliest period practicable and discloses the data that are not adjusted to comply with FRS 102. If it is impracticable to give comparative disclosures, any omissions are disclosed. [FRS102.35.11]

#### Mandatory exceptions to retrospective application

35.10 On transition to FRS 102 an entity does not retrospectively change its accounting for the following:

(a) derecognition of financial assets and liabilities:

- i. when these were derecognised under the previous framework they are not recognised on transition to FRS 102; and
- ii. when these would have been derecognised under FRS 102 but were not derecognised under the previous framework, an entity can choose either to derecognise them on transition or to continue to recognise them until disposed of or settled;

(b) accounting estimates – when an accounting estimate was made under the previous GAAP this is not changed on transition;

(c) discontinued operations – if the definition of a discontinued operation under the previous GAAP is not the same as under FRS 102 the comparative financial information is not restated;

(d) non-controlling interest (NCI) – an entity accounts prospectively from the date of transition for the following, unless the entity restates its business combinations from an earlier date (see paragraph 35.12 of this publication):

- i. the allocation of profit and total comprehensive income between the owners of the parent and the NCI;
- ii. changes in the parent's ownership interest in a subsidiary that does not result in a loss of control;
- iii. loss of control over a subsidiary. [FRS102.35.9(e)]

## Optional first-time adoption exemptions

35.11 A number of optional exemptions are also available to first-time adopters of FRS 102, as set out below: an entity may choose to take advantage of none, some or all of these. The entity may continue to apply the exemptions until the relevant assets or liabilities are derecognised. When there is a significant change in circumstances related to these assets and liabilities, an entity assesses whether continuing to apply the exemption would maintain a fair presentation in line with Section 3 *Financial statement presentation*. [FRS102.35.11A,B]

### Business combinations

35.12 Section 19 *Business combinations and goodwill* must be applied by an entity to all business combinations taking place after its date of transition (which will include those in the comparative period in its first FRS 102 financial statements). It may choose not to restate business combinations or group reconstructions taking place before that date. Similarly, a public benefit entity may choose not to apply Section 34 *Specialised activities* to public benefit entity combinations before the transition date. If the entity chooses to apply Sections 19/34 to such a combination it restates all later combinations. [FRS102.35.10(a),(q)]

35.13 When an entity does not retrospectively apply Section 19, the previously acquired assets and liabilities are recognised in line with paragraphs 35.5 to 35.10 and 35.18 to 35.38 of this publication except that:

- intangible assets previously included in goodwill are not recognised separately; and
- the carrying amount of goodwill is not adjusted. [FRS102.35.10(a)(ii)]

As goodwill is not adjusted on transition if this exemption is applied, any adjustments to the carrying amount of acquired assets and liabilities made to meet the requirements of FRS 102 (for example, the recognition of deferred tax on acquired assets or liabilities) are recognised in retained earnings on transition.

35.14 Under previous UK GAAP, SSAP 20 did not specify the treatment of goodwill arising from the acquisition of a foreign operation and two approaches emerged in practice. Either goodwill was treated as a non-monetary asset with no retranslation, or it was treated as an asset of the foreign operation and retranslated at the year-end exchange rate. FRS 102.30.23 requires goodwill to be denominated in the functional currency of the acquired entity and retranslated at closing rate. FRS 102.35.10(a)(ii) states that no adjustment shall be made to the carrying value of goodwill if the business combinations transition relief is taken. However, there is no transition relief from FRS 102.30.23. The question arises as to how existing 'foreign goodwill' should be accounted for, if in the past it was not retranslated. A number of approaches appear to be possible and diversity may arise in practice.

35.15 One view is that, in the absence of specific guidance in FRS 102, if an entity elects to take the exemption from restating past business combinations then FRS 102.30.23 should apply only to goodwill arising on acquisitions on or after the transition date (or the date from which the entity elects to restate past business combinations). Goodwill that had not previously been retranslated would effectively be treated as being expressed in the parent entity's functional currency, or a non-monetary asset of the parent, and would not be retranslated on transition or subsequently. This approach would be consistent with that permitted under IFRS 1.

35.16 An alternative view, representing a literal reading of the requirements of both sections of FRS 102, would be to recognise an exchange adjustment on all existing 'foreign goodwill' as a catch-up immediately after transition date, thereby following FRS 102.35.10(a)(ii) by not making any adjustment on transition date. Thereafter, exchange differences would be recognised in each reporting period.

35.17 A third approach is to argue that an adjustment could be made to goodwill at the transition date and still follow FRS 102.35.10(a)(ii). This would be on the basis that the underlying foreign currency goodwill number itself had not been changed.

35.18 When an entity determined under a previous GAAP that goodwill had an indefinite useful life, it will need to reassess goodwill to determine its useful life under FRS 102 and amortise over that period going forward. [FRS102.ACA.161] As noted above, the carrying amount of goodwill is not adjusted on transition. Therefore, no retrospective adjustment is made to the carrying value of goodwill that has previously been treated as having an indefinite useful life. Instead, it is amortised over a finite useful life from the date of transition.

35.19 When an entity previously determined a finite useful life for goodwill, the entity will continue to amortise goodwill over that period provided that its estimate of the useful life has not changed and can be estimated reliably, even if that life exceeds five years. If an entity is, unusually, unable to estimate the useful life of goodwill reliably, it cannot exceed five years<sup>1</sup> (see paragraph 19.22 of this publication). [FRC SEN13]

1. The maximum period is ten years for periods beginning on or after 1 January 2016 (or earlier adoption of the July 2015 amendments to FRS 102 – see paragraph INT.6 of this publication). The July 2015 amendments to FRS 102 also clarify that an inability to make a reliable estimate of the useful life of goodwill is expected to arise only in exceptional cases.

### Share-based payment transactions

35.20 An entity is not required to apply Section 26 *Share-based payment* to equity instruments granted before the transition date, or to share-based payment liabilities that were settled before the transition date. Entities previously applying FRS 20/IFRS 2 continue to apply that standard at the date of transition to equity instruments granted before the transition date. Alternatively they may choose to apply Section 26. [FRS102.35.10(b)]

### Fair value or revaluation as deemed cost

35.21 An entity may use either the fair value at the transition date, or a previous revaluation (under the previous GAAP) at or before the transition date, of an item of property, plant and equipment, investment property or intangible asset (when eligible for revaluation under Section 18 *Intangible assets other than goodwill*, see paragraph 18.19 of this publication) as its deemed cost on transition. [FRS102.35.10(c),(d)] This exemption may be applied on an asset by asset basis.

35.22 For entities to which the Companies Act applies, a gain arising as a result of recognising an item of property, plant and equipment or an intangible asset at fair value on transition is recognised in a revaluation reserve rather than retained earnings. Any such revaluation reserve established under previous UK GAAP is retained on transition to FRS 102. No revaluation reserve is required under the Companies Act in respect of investment property. [FRS102.A4.28] However, the revaluation reserve is not distributable as qualifying consideration has not been received and, for this reason, we expect many entities to continue to recognise a revaluation reserve in respect of investment property. In such cases, the investment property revaluation reserve established under previous UK GAAP is retained on transition to FRS 102; otherwise it is transferred to retained earnings on transition. Note that under FRS 102 deferred tax is recognised on revaluations and assets carried at deemed cost (see Chapter 29 of this publication). The effect of this at the date of transition will be recognised in the corresponding revaluation reserve or retained earnings, as applicable. [FRC SEN13]

### Individual and separate financial statements

35.23 If an entity chooses to measure its investment in subsidiaries, associates or joint ventures at cost under Section 9 *Consolidated and separate financial statements*, 14 *Investments in associates* or 15 *Investments in joint ventures* respectively, then the opening cost is determined in line with that section or may be deemed to be the carrying amount at the transition date under the previous GAAP. [FRS102.35.10(f)]

### Compound financial instruments

35.24 If the liability element of a compound instrument is not outstanding at the transition date, an entity is not required to split the instrument into its equity and liability components. [FRS102.35.10(g)]

### Designation of previously recognised financial instruments

35.25 FRS 102 permits certain financial instruments to be designated on initial recognition as at fair value through profit or loss. FRS 102.35.10(s) permits any financial asset or financial liability that meets the criteria in FRS 102.11.14(b) at the transition date to be designated at fair value through profit or loss as at that date. [FRS102.35.10(s)]

### Hedge accounting

35.26 For hedging relationships that exist on the date of transition, an entity may apply the hedge accounting provisions of Section 12 *Other financial instrument issues* from that date, provided that the required documentation is put in place no later than the date on which the first FRS 102 financial statements are authorised for issue, and the remaining hedge accounting criteria are met as at the date of transition.

35.27 For hedging relationships that ceased to exist before the date of transition, i.e. because the hedging instrument expired or was sold, terminated or exercised prior to that date, the entity may elect not to adjust the carrying amount of an asset or liability for the effects of any hedge accounting under the previous GAAP. Further, the entity may elect to account for amounts recognised in equity in relation to a cash flow hedge under the previous GAAP in accordance with paragraph 12.23(d) of the standard (see paragraph 12.58 of this publication).

35.28 For hedging relationships that commenced after the date of transition, the entity may apply the hedge accounting provisions of Section 12 from the date that the hedging criteria are met, provided that the documentation requirements are met no later than the date on which the first FRS 102 financial statements are authorised for issue.

(1) FRED 59 (issued February 2015) proposes to change this maximum period to ten years for periods beginning on or after 1 January 2016 to align with the new EU Accounting Directive.

35.29 Entities applying the requirements of IAS 39 or IFRS 9 rather than Sections 11 *Basic financial instruments* and 12 are not eligible for the exemptions in paragraphs 35.26 to 35.28 above. Instead, they apply the transition requirements of IFRS 1 in relation to hedge accounting, except that the designation and documentation of the hedge relationship may be completed after the date of transition, but no later than the date on which the first FRS 102 financial statements are authorised for issue. [FRS102.35.10(t)] In addition to the documentation requirements, IAS 39 and IFRS 9 require entities to consider ineffectiveness during the hedged period. Given that, on transition, entities have additional time to put in place hedge documentation, it would seem consistent to allow additional time to consider ineffectiveness since it will be the documentation that details the nature and timing of the considerations of ineffectiveness. However, whilst we believe entities can defer the consideration of ineffectiveness until the documentation is in place, in our view, if IAS 39 is adopted the entity should go back and prepare: a prospective test as if prepared on the transition date; and a retrospective test and prospective test as if prepared on the current and comparative reporting dates to ensure the tests were passed. If IFRS 9 is adopted then the entity should ensure that any ineffectiveness occurring between the transition date and the reporting date is calculated and appropriately accounted for.

#### Service concession arrangements

35.30 From the operator's perspective, when service concession arrangements were entered into before the date of transition (i.e. the arrangement had reached legal completion of the terms of the arrangement/financial close) then the operator is not required to apply paragraphs 34.121 to 34.16A of FRS 102, being the recognition requirements for service concession arrangements, to those service concessions. Instead, the operator continues to account for the arrangement using the same accounting policies as were applied at the date of transition to FRS 102. [FRS102.35.10(i)] No similar transitional relief is available for grantors.

35.31 When the transitional relief is utilised, previous accounting policies will be applied to the classification of, and subsequent accounting for, the asset arising and the service concession arrangement itself. The transitional relief would not extend to other elements of the entity's accounting such as its financing or taxation arrangements.

#### Extractive activities

35.32 Under previous UK GAAP, an entity may have accounted for exploration and evaluation assets together with assets in the development and production phases in the same cost centres, which included all properties in a large geographical area. At the transition date the entity may elect to measure those assets under a previous GAAP whilst accounting for them separately. The total carrying value of the cost centre is allocated using amounts determined under the entity's previous GAAP between exploration and evaluation assets on the one hand, and assets in the development or production phases on the other. The development or production asset total is further allocated to underlying assets pro rata on the basis of reserve volumes or values as of that date. The entity will then test these exploration and evaluation assets and assets in the development and production phases for impairment under Section 34 and Section 27 *Impairment of assets* respectively, which may result in reductions in the carrying amounts of the assets determined under these transitional arrangements. [FRS102.35.10(j)]

#### Lease arrangements

35.33 An entity may choose to assess whether an arrangement contains a lease using the facts and circumstances at the transition date rather than the commencement date of the arrangement. [FRS102.35.10(k)]

#### Lease incentives

35.34 When a lease commenced before transition date, an entity can continue to recognise lease incentives under its previous GAAP. [FRS102.35.10(p)] However, note that if the exemption is not applied, accounting for the lease incentive under FRS 102 will likely result in a catch-up charge on transition and a higher charge in the earlier years of the lease. This charge is tax-deductible so may result in a cash tax benefit.

#### Decommissioning liabilities included in the cost of property, plant and equipment

35.35 An entity can choose to measure the decommissioning cost that is included in the cost of the related property, plant and equipment under FRS 102.17.10(c) at the transition date or at the original obligation date. [FRS102.35.10(l)]

#### Dormant companies (UK only)

35.36 A company within the Companies Act definition of dormant at and from the date of transition may retain its existing accounting policies until a change occurs in its existing account balances, or it undertakes a new transaction. [FRS102.35.10(m)] A dormant company's date of transition will be determined based on the period in which it makes a full and unreserved statement of compliance with FRS 102, even if no adjustments are recognised in that period. If in a subsequent



period it ceases to be dormant, FRS 102 will need to be applied in full and Section 35 (and the exemptions therein) will not apply in that period since it will not at that stage be a first-time adopter. [FRS102.35.1] This exemption is also available to entities other than companies (e.g. LLPs) that have a similar status under the Companies Act.

#### Deferred development costs as deemed cost

35.37 An entity may choose to take costs deferred in accordance with SSAP 13 as the deemed cost at transition date. [FRS102.35.10(n)]

#### Borrowing costs

35.38 An entity may use the transition date as the date on which capitalisation of borrowing costs on qualifying assets commences, if it chooses to adopt a policy of capitalisation under FRS 102. [FRS102.35.10(o)]

#### Related entities adopting FRS 102 at different dates

35.39 If a subsidiary, associate, or joint venture adopts FRS 102 after its investor, the assets and liabilities of the subsidiary, associate or joint venture are measured in its financial statements at:

- the carrying amounts that would be included in the investor's consolidated financial statements if no adjustments were made for consolidation procedures, and for the effects of the business combination in which the entity was acquired; or
- the carrying amounts under FRS 102, which may differ from the above if the entity had previously been acquired in a business combination, takes transition exemptions, or has different accounting policies from its investor. [FRS102.35.10(r)]

35.40 If an entity adopts FRS 102 after its subsidiary, associate or joint venture, its consolidated financial statements include the same amounts for assets and liabilities as in the financial statements of that subsidiary, associate or joint venture, adjusted for consolidation and the acquisition of the entity. [FRS102.35.10(r)]

35.41 If a parent adopts FRS 102 in its separate financial statements after or before it has done so in its consolidated financial statements, it includes the same amounts in both financial statements, except for consolidation adjustments. [FRS102.35.10(r)]

#### Disclosures

35.42 An entity discloses the impact of transitioning to FRS 102 on its financial position and financial performance. [FRS102.35.12] This includes:

- (a) an explanation of any changes in accounting policy;
- (b) a reconciliation of the entity's equity under its previous GAAP to its equity determined under FRS 102 at the transition date, and at its last period end date for which financial statements were presented under its previous GAAP. For example, if an entity's first financial statements prepared under FRS 102 are for the year ended 31 December 2015, with comparatives shown under FRS 102 for the year ended 31 December 2014, and the latest period for which it presented previous UK GAAP accounts was the year ended 31 December 2014, then the entity presents reconciliations between its equity under previous UK GAAP and under FRS 102 at 1 January 2014 (the date of transition) and at 31 December 2014 (last period end under its previous GAAP);
- (c) a reconciliation of the entity's profit or loss in respect of the latest period in the entity's most recent annual financial statements between that calculated under its previous GAAP and its profit or loss under FRS 102. Continuing with the example in (b), the reconciliation is between the profit or loss under previous UK GAAP and under FRS 102 for the year ended 31 December 2014. [FRS102.35.13]

35.43 There is no explicit requirement to disclose the impact of the transition on the cash flow statement (when presented). However, if the impact is material (which is likely to be the case when moving from previous UK GAAP to FRS 102) it may be appropriate to give a narrative explanation of this, e.g. reclassification between categories of cash flow or the introduction of cash equivalents under FRS 102.

35.44 If an entity identifies any errors under its previous GAAP accounting then it displays these separately in its reconciliations (paragraphs 35.42(b) and (c) of this publication) from any changes in accounting policy. [FRS102.35.14]

35.45 An opening balance sheet at the date of transition to FRS 102 is not required to be presented. [FRS102.35.7]

35.46 If an entity has not previously presented financial statements, it states this in its first financial statements under FRS 102. [FRS102.35.15]

## vs previous UK GAAP

## Applicable standards: None

pUK35.1 There are no requirements or exemptions, and no guidance, on first-time adoption of, or transition to, previous UK GAAP. An entity applying previous UK GAAP for the first time would therefore need to apply all previous UK GAAP requirements retrospectively for any transactions or balances in the financial statements at the date of transition, except to the extent that the standard in question applied prospectively from a specific date.

## vs EU-IFRS

## Applicable standards: IFRS 1

IFRS35.1 IFRS 1 requires presentation of a third statement of financial position, at the transition date, adjacent to those for the reporting date and comparative period end.

IFRS35.2 The appendices to IFRS 1 include lists of possible exemptions on transition to IFRS. There are exemptions that are additional to the list in Section 35 *Transition to FRS 102*, including exemptions relating to transfers of assets from customers, financial asset and liability recognition and severe hyperinflation. There are also exemptions in Section 35 that are not in the IFRS 1 appendix, including that relating to dormant companies.

IFRS35.3 The reconciliation disclosure requirements under FRS 102 are less detailed than under IFRS 1. IFRS 1.25 requires sufficient detail to be given to understand the material adjustments to the statement of financial position, statement of comprehensive income and statement of cash flows. FRS 102 requires a reconciliation of equity and of profit and is not specific about the level of detail required to be given for material adjustments.



# 36 Insurance contracts

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## OVERVIEW OF REQUIREMENTS

- FRS 103 applies to all entities that apply FRS 102 and that issue insurance contracts, not just to those entities that are constituted as insurance companies or entities with an insurance business.
  - FRS 103 also applies to financial instruments with discretionary participation features.
  - FRS 103 is based largely on IFRS 4 and consolidates existing accounting requirements and guidance for insurance contracts.
  - FRS 103 allows entities, generally, to continue with their existing accounting policy for insurance contracts but permits entities to make improvements.
  - FRS 103 includes disclosure requirements over and above those currently required under UK law and contains no disclosure exemption for captive insurers.
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## FRS 103

36.1 FRS 103 consolidates existing financial reporting requirements and guidance for insurance contracts. It is based largely on the requirements of IFRS 4, FRS 27 and elements of the Association of British Insurers' Statement of Recommended Practice (ABI SORP), but amended to reflect the requirements of company law. FRS 27 and the ABI SORP are withdrawn with effect from 1 January 2015.

36.2 Since the FRC expects FRS 103 to have a limited life (i.e. the FRC expects to review it once the IASB has issued its revised IFRS 4), the standard permits entities, generally, to continue with their existing accounting policies for insurance contracts. The FRC is also considering revisions to FRS 103 to reflect changes to solvency standards.

### Scope

36.3 FRS 103 applies to entities that apply FRS 102 and:

- issue insurance or reinsurance contracts;
- hold reinsurance contracts; and/or
- issue financial instruments with a discretionary participation feature. [FRS103.1.2]

This means that FRS 103 is potentially relevant to all types of entity that apply FRS 102, not just those with an insurance business, e.g. life and general insurers.

36.4 A discretionary participation feature is defined as a contractual right to receive, as a supplement to guaranteed benefits, additional benefits:

- (a) that are likely to be a significant portion of the total contractual benefits;
- (b) whose amount or timing is contractually at the discretion of the issuer; and
- (c) that are contractually based on:
  - i. the performance of a specified pool of contracts or a specified type of contract;
  - ii. realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
  - iii. the profit or loss of the company, fund or the entity that issues the contract. [FRS103.GL]

### Insurance contracts

36.5 FRS 103 (and FRS 102) defines an insurance contract as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. Insurance risk is risk, other than financial risk, transferred from the holder of a contract to the issuer. [FRS103.GL] This definition is consistent with the definition currently included within FRS 26.

36.6 For those entities that have not applied FRS 26 previously, this definition will be new and they will now be required to assess whether their contracts meet the definition of an insurance contract (and hence fall within the scope of FRS 103). Those contracts that do not meet the definition fall within the scope of Section 11 *Basic financial instruments*, Section 12 *Other financial instruments issues*, or Section 21 *Provisions and contingencies*.

36.7 Contracts that do meet the definition of insurance contracts but which are specifically excluded from FRS 103 include:

- product warranties issued directly by the manufacturer, dealer or retailer; and
- financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts.

These contracts will be accounted for instead under Section 21.

36.8 An example of a type of contract that falls within the scope of FRS 103 is product warranty contracts written for goods sold by third party manufacturers, dealers or retailers. [FRS103.A2.18]

## Measurement

36.9 FRS 103, like IFRS 4, allows entities to continue with their existing accounting policies for insurance contracts.

36.10 Regardless of whether an entity has an insurance business (and continues to account for insurance contracts in accordance with the ABI SORP and FRS 26 or FRS 27) or not (and continues to account for insurance contracts in accordance with FRS 12 and FRS 26), an entity would still need to consider the other requirements of FRS 103, including:

- an entity shall not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the end of the reporting period (unless otherwise required by law or regulation);
- an entity shall carry out a liability adequacy test in accordance with paragraphs 2.14 to 2.18 of FRS 103;
- an entity shall remove an insurance liability from the statement of financial position only when it is extinguished;
- an entity shall not offset:
  - reinsurance assets against the related insurance liabilities; or
  - income or expense from reinsurance contracts against the expense or income from the related insurance contracts; and
- an entity shall consider whether its reinsurance assets are impaired. [FRS103.2.13]

36.11 Again like IFRS 4, FRS 103 allows an entity the same flexibility to change its accounting policy so long as the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs of users. [FRS103.2.3]

36.12 If an entity decides to change its existing accounting policy, it may, but is not required to:

- remeasure designated insurance liabilities to reflect current market interest rates and recognise changes in those liabilities in profit or loss; [FRS103.2.5] and
- if realised gains and losses on an insurer's assets have a direct effect on the measurement of some or all of its insurance liabilities (and related deferred acquisition costs and intangible assets), the entity may remeasure those insurance liabilities for recognised but unrealised gains and losses. The adjustment to the insurance liability (or deferred acquisition costs or intangible assets) is recognised in other comprehensive income (OCI) if, and only if, the unrealised gains or losses on the asset are recognised through OCI. [FRS103.2.11]

36.13 FRS 103 allows entities to continue with the following practices but does not allow entities to move to these practices:

- measuring insurance liabilities on an undiscounted basis (unless otherwise required by law or regulation);
- measuring contractual rights to future investment management fees at an amount that exceeds their fair value (as implied by a comparison with current fees charged by other market participants for similar services);
- using non-uniform accounting policies for the insurance contracts (and related deferred acquisition costs and intangible assets) of subsidiaries; [FRS103.2.6] and
- including future investment margins, unless those margins affect the contractual payments. [FRS103.2.8]

36.14 Separable embedded derivatives, when the derivative is not an insurance contract, shall be separated from the host contract – for example, a cash surrender option if the surrender value varies in response to a change in a financial variable or a non-financial variable that is not specific to a party to the contract. An insurer need not separate a policyholder's option to surrender an insurance contract for a fixed amount. [FRS103.2.20,21]

36.15 FRS 103 permits entities to treat all assets and liabilities arising from insurance contracts, e.g. deferred acquisition costs and reinsurance balances, as if they were monetary items for the purposes of Section 30 *Foreign currency translation* and therefore retranslate them at the closing rate at the period end. [FRS103.2.26]

## Disclosure

36.16 The disclosure requirements in Section 4 of FRS 103 apply to all entities that issue insurance contracts and/or financial instruments with discretionary participation features. There are additional disclosure requirements in Section 5 of FRS 103 that apply only for those entities with long-term insurance contracts.

36.17 All entities are required to disclose information that identifies and explains the amounts recognised in the financial statements and the related risks and uncertainties with those balances, if they meet the definition of an insurance contract and therefore fall within the scope of FRS 103. For an entity that has not previously applied FRS 26, the additional disclosures required by FRS 102 and FRS 103 are likely to be significant, with disclosure required of exposure to insurance risks and financial risks and sensitivity analysis of any changes in the risk variables. For entities that are not insurance companies and have therefore not disclosed information about insurance risk before, the new disclosures will also be significant.

36.18 One example of when additional/new disclosures will be required is the need for a movement analysis for any asset or liability recognised, since typically many such items have previously been accounted for as financial instruments, and a movement analysis is not required for financial instruments.

36.19 Consistently with IFRS 4, FRS 103 includes a requirement to disclose claims development information over a ten-year period. This goes beyond that required by the Regulations.

36.20 FRS 103 provides no disclosure exemption for captive insurers (a captive is an entity that provides insurance cover for other entities in the group to which it belongs). The disclosure exemptions that existed in FRS 27 for 90 percent subsidiaries within a group have also been removed.

## Transition

36.21 As entities are allowed to retain their existing accounting policies for insurance contracts, there are no transitional provisions in FRS 103 in respect of recognition and measurement. FRS 103 allows the claims development activity information not to be presented for periods more than five years before first application.

## vs previous UK GAAP

### Applicable standards: FRS 27, ABI SORP

#### Life assurance contracts

pUK36.1 For entities with a life insurance business, the principal requirements, other than those set out in the Association of British Insurers (ABI) SORP and in legislation, i.e. Schedule 3 of the Regulations, are contained in FRS 27.

pUK36.2 FRS 103 allows entities to continue applying FRS 27 to existing life insurance contracts; new business should also follow a consistent accounting policy unless a change (for all contracts) can be justified under paragraphs 2.3 to 2.11 in FRS 103.

#### Non-life insurance contracts

pUK36.3 There were no accounting standards in UK GAAP that dealt with the accounting for non-life insurance contracts. Guidance was contained in the ABI SORP and in legislation.

pUK36.4 FRS 103 allows entities to continue applying their existing accounting policies for insurance contracts; as above, new contracts should also follow a consistent accounting policy unless a change (for all contracts) can be justified under paragraphs 2.3 to 2.11 in FRS 103.

## vs EU-IFRS

### Applicable standards: IFRS 4

IFRS36.1 The principles in FRS 103 are broadly consistent with IFRS 4.

IFRS36.2 When recognised separately from any guaranteed element of an insurance contract, discretionary participation features in insurance contracts may be accounted for under IFRS 4 (under FRS 103 by non-Companies Act entities) as equity or as a liability but Schedule 3 of the Regulations requires presentation as a liability by Companies Act entities.

IFRS36.3 Like FRS 102, IFRS 4 allows an existing accounting policy that measures insurance liabilities on an undiscounted basis but prohibits adoption of any new accounting policy that does not involve discounting.





# Appendix

## **APPENDIX I: LIST OF STANDARDS AND INTERPRETATIONS REFERRED TO IN THIS PUBLICATION**

### NEW UK GAAP STANDARDS

FRS 100 Application of Financial Reporting Requirements

FRS 101 Reduced Disclosure Framework

FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland

FRS 103 Insurance Contracts

FRS 104 Interim Financial Reporting

FRS 105 The Financial Reporting Standard applicable to the Micro-Entities Regime

Financial Reporting Standard for Smaller Entities (effective 1 January 2015)

### STATEMENTS OF RECOMMENDED PRACTICE (SORPS)

Accounting for further and higher education (March 2014)

Financial statements of UK authorised funds (May 2014)

Accounting and Reporting by Charities (FRS 102) (July 2014)

Accounting and Reporting by Charities (FRSSE) (July 2014)

Accounting by Limited Liability Partnerships (July 2014)

Accounting by registered social housing providers (September 2014)

Financial statements of investment trust companies and venture capital trusts (November 2014)

Financial Reports of Pension Schemes (November 2014)

### PREVIOUS UK GAAP STANDARDS AND ABSTRACTS

#### Standards

SSAP 4 Accounting for government grants

SSAP 5 Accounting for value added tax

SSAP 9 Stocks and long-term contracts

SSAP 13 Accounting for research and development

SSAP 19 Accounting for investment properties

SSAP 20 Foreign currency translation

SSAP 21 Accounting for leases and hire purchase contracts

SSAP 25 Segmental reporting

FRS 1 Cash flow statements

FRS 2 Accounting for subsidiary undertakings

FRS 3 Reporting financial performance

FRS 4 Capital instruments

FRS 5 Reporting the substance of transactions

FRS 6 Acquisitions and mergers

FRS 7 Fair values in acquisition accounting

FRS 8 Related party disclosures

FRS 9 Associates and joint ventures

FRS 10 Goodwill and intangible assets

FRS 11 Impairment of fixed assets and goodwill

FRS 12 Provisions, contingent liabilities and contingent assets

FRS 13 Derivatives and other financial instruments: disclosures

FRS 15 Tangible fixed assets

FRS 16 Current tax

FRS 17 Retirement benefits

FRS 18 Accounting policies

FRS 19 Deferred tax

FRS 20 (IFRS 2) Share-based payment

FRS 21 (IAS 10) Events after the balance sheet date

FRS 22 (IAS 33) Earnings per share

FRS 23 (IAS 21) The effects of changes in foreign exchange rates

FRS 24 (IAS 29) Financial reporting in hyperinflationary economies

FRS 25 (IAS 32) Financial instruments: Presentation

FRS 26 (IAS 39) Financial instruments: recognition and measurement

FRS 27 Life assurance

FRS 28 Corresponding amounts

FRS 29 (IFRS 7) Financial instruments: disclosures

FRS 30 Heritage assets

FRSSE Financial Reporting Standard for Smaller Entities (April 2008)

## Urgent Issues Task Force (UITF) abstracts

UITF 4 Presentation of long-term debtors in current assets

UITF 5 Transfers from current assets to fixed assets

UITF 9 Accounting for operations in hyper-inflationary economies

UITF 11 Capital instruments: issuer call options

UITF 15 Disclosure of substantial acquisitions

UITF 19 Tax on gains and losses on foreign currency borrowings that hedge an investment in a foreign enterprise

UITF 21 Accounting issues arising from the proposed introduction of the euro

UITF 22 The acquisition of a Lloyd's business

UITF 23 Application of the transitional rules in FRS 15

UITF 24 Accounting for start-up costs

UITF 25 National Insurance contributions on share option gains

UITF 26 Barter transactions for advertising

UITF 27 Revision to estimates of the useful economic life of goodwill and intangible assets

UITF 28 Operating lease incentives

UITF 29 Website development costs

UITF 31 Exchanges of businesses or other non-monetary assets for an interest in a subsidiary, joint venture or associate

UITF 32 Employee benefit trusts and other intermediate payment arrangements

UITF 34 Pre-contract costs

UITF 35 Death-in-service and incapacity benefits

UITF 36 Contracts for sales of capacity

UITF 38 Accounting for ESOP trusts

UITF 39 (IFRIC 2) Members' shares in co-operative entities and similar instruments

UITF 40 Revenue recognition and service contracts

UITF 42 (IFRIC 9) Reassessment of Embedded Derivatives

UITF 43 The interpretation of equivalence for the purposes of section 228A of the Companies Act 1985

UITF 45 (IFRIC 6) Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment

UITF 46 (IFRIC 16) Hedges of a Net Investment in a Foreign Operation

UITF 47 (IFRIC 19) Extinguishing Financial Liabilities with Equity Instruments

UITF 48 Accounting implications of the replacement of the retail prices index with the consumer prices index for retirement benefits

## EU-IFRS STANDARDS AND INTERPRETATIONS

### Standards

IFRS 1 First-time Adoption of International Financial Reporting Standards

IFRS 2 Share-based Payment

IFRS 3 Business Combinations

IFRS 4 Insurance Contracts

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

IFRS 6 Exploration for and Evaluation of Mineral Resources

IFRS 7 Financial Instruments: Disclosures

IFRS 8 Operating Segments

IFRS 9 Financial Instruments (Not endorsed by the EU as at September 2015)

IFRS 10 Consolidated Financial Statements

IFRS 11 Joint Arrangements

IFRS 12 Disclosure of Interests in Other Entities

IFRS 13 Fair Value Measurement

IFRS 14 Regulatory Deferral Accounts (Not endorsed by the EU as at September 2015)

IFRS 15 Revenue from Contracts with Customers (Not endorsed by the EU as at September 2015)

IAS 1 Presentation of Financial Statements

IAS 2 Inventories

IAS 7 Statement of Cash Flows

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

IAS 10 Events after the Reporting Period

IAS 11 Construction Contracts<sup>1</sup>

IAS 12 Income Taxes

IAS 16 Property, Plant and Equipment

IAS 17 Leases

IAS 18 Revenue<sup>1</sup>

IAS 19 Employee Benefits

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

IAS 21 The Effects of Changes in Foreign Exchange Rates

IAS 23 Borrowing Costs

<sup>1</sup> Superseded on adoption of IFRS 15

IAS 24 Related Party Disclosures

IAS 26 Accounting and Reporting by Retirement Benefit Plans

IAS 27 Separate Financial Statements

IAS 28 Investments in Associates and Joint Ventures

IAS 29 Financial Reporting in Hyperinflationary Economies

IAS 32 Financial Instruments: Presentation

IAS 33 Earnings per Share

IAS 34 Interim Financial Reporting

IAS 36 Impairment of Assets

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

IAS 38 Intangible Assets

IAS 39 Financial Instruments: Recognition and Measurement

IAS 40 Investment Property

IAS 41 Agriculture

## Interpretations

IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities

IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments

IFRIC 4 Determining whether an Arrangement contains a Lease

IFRIC 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

IFRIC 6 Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment

IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies

IFRIC 9 Reassessment of Embedded Derivatives

IFRIC 10 Interim Financial Reporting and Impairment

IFRIC 12 Service Concession Arrangements

IFRIC 13 Customer Loyalty Programmes<sup>1</sup>

IFRIC 14 IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

IFRIC 15 Agreements for the Construction of Real Estate<sup>1</sup>

IFRIC 16 Hedges of a Net Investment in a Foreign Operation

IFRIC 17 Distributions of Non-cash Assets to Owners

IFRIC 18 Transfers of Assets from Customers<sup>1</sup>

IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments

IFRIC 20 Stripping Costs in the Production Phase of a Surface Mine

IFRIC 21 Levies

SIC-7 Introduction of the Euro

SIC-10 Government Assistance – No Specific Relation to Operating Activities

SIC-15 Operating Leases – Incentives

SIC-25 Income Taxes – Change in the Tax Status of an Entity or its Shareholders

SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease

SIC-29 Service Concession Arrangements: Disclosures

SIC-31 Revenue – Barter Transactions Involving Advertising Services<sup>1</sup>

SIC-32 Intangible Assets – Web Site Costs

# Appendix

## APPENDIX II: COMMON PROFIT AND LOSS ACCOUNT AND BALANCE SHEET FORMATS FROM SCHEDULES 1 AND 6 TO THE REGULATIONS

### PROFIT AND LOSS ACCOUNT

#### FORMAT 1<sup>1</sup>

1. Turnover
2. Cost of sales
3. Gross profit or loss
4. Distribution costs
5. Administrative expenses
6. Other operating income
7. Income from shares in group undertakings
8. Income from participating interests<sup>2</sup>
9. Income from other fixed asset investments<sup>3</sup>
10. Other interest receivable and similar income<sup>3</sup>
11. Amounts written off investments
12. Interest payable and similar charges<sup>4</sup> [expenses]<sup>8</sup>  
**Profit or loss [on ordinary activities]<sup>8</sup> before taxation<sup>5</sup>**
13. Tax on profit or loss [on ordinary activities]<sup>8</sup>
14. Profit or loss [on ordinary activities]<sup>8</sup> after taxation  
*Non-controlling interests<sup>6</sup>*
15. [Extraordinary<sup>7</sup> income]
16. [Extraordinary<sup>7</sup> charges]
17. [Extraordinary<sup>7</sup> profit or loss]
18. [Tax on extraordinary<sup>7</sup> profit or loss]  
*[Non-controlling interests<sup>6</sup> in respect of extraordinary<sup>7</sup> items]*
19. Other taxes not shown under the above items
20. Profit or loss for the financial year

<sup>1</sup>The amount of any provisions for depreciation and diminution in value of tangible and intangible fixed assets is disclosed in a note to the accounts.

<sup>2</sup>In group accounts, when the group has an investment in an associate or joint venture, replace this heading with two headings: 'Income from interests in associated undertakings' (being the associate and/or joint venture) and 'Income from other participating interests'.

<sup>3</sup>Income and interest derived from group undertakings is shown separately from income and interest derived from other sources.

<sup>4</sup>The amount payable to group undertakings is shown separately.

<sup>5</sup>Schedule 1 Part 1 Section A Paragraph 6.

<sup>6</sup>Treated as an item to which an Arabic number is assigned (see notes to formats). Described as minority interests in the Regulations, although the Regulations state that an appropriate alternative description of this line item may be used, hence the FRS 102 term 'non-controlling interests' is used here.

<sup>7</sup>Extraordinary items are not expected to occur in practice and with effect from periods beginning on or after 1 January 2016 (early-adoption is permitted as discussed in paragraph INT.7 of this publication) are removed from the Regulations.



## Format 2

1. Turnover
2. Change in stocks of finished goods and in work in progress
3. Own work capitalised
4. Other operating income
5. (a) Raw materials and consumables  
(b) Other external charges [expenses]<sup>8</sup>
6. Staff costs  
(a) wages and salaries  
(b) social security costs  
(c) other pension costs
7. (a) Depreciation and other amounts written off tangible and intangible fixed assets  
(b) Exceptional amounts written off current assets [Amounts written off current assets to the extent that they exceed write-offs which are normal in the undertaking concerned]<sup>9</sup>
8. Other operating charges [expenses]<sup>8</sup>
9. Income from shares in group undertakings
10. Income from participating interests<sup>2</sup>
11. Income from other fixed asset investments<sup>3</sup>
12. Other interest receivable and similar income<sup>3</sup>
13. Amounts written off investments
14. Interest payable and similar charges<sup>4</sup> [expenses]<sup>8</sup>  
**Profit or loss [on ordinary activities]<sup>8</sup> before taxation<sup>5</sup>**
15. Tax on profit or loss [on ordinary activities]<sup>8</sup>
16. Profit or loss [on ordinary activities]<sup>8</sup> after taxation  
*Non-controlling interests<sup>6</sup>*
17. [Extraordinary<sup>7</sup> income]
18. [Extraordinary<sup>7</sup> charges]
19. [Extraordinary<sup>7</sup> profit or loss]
20. [Tax on extraordinary<sup>7</sup> profit or loss]  
*[Non-controlling interests<sup>6</sup> in respect of extraordinary<sup>7</sup> items]*
21. Other taxes not shown under the above items
22. Profit or loss for the financial year

<sup>8</sup> SI 2015/980 amends the Regulations with effect from periods beginning on or after 1 January 2016 (early-adoption is permitted as discussed in paragraph INT.7 of this publication) to replace the word 'charges' with 'expenses' and omit the term 'on ordinary activities.'

<sup>9</sup> SI 2015/980 amends the Regulations with effect from 1 January 2016 to replace 'Exceptional amounts written off current assets' with the terminology shown in square brackets for a Format 2 profit and loss account.

## BALANCE SHEET - FORMAT 1

### A Called up share capital not paid<sup>10</sup>

### B Fixed assets

#### I Intangible assets

- 1 Development costs
- 2 Concessions, patents, licences, trade marks and similar rights and assets
- 3 Goodwill
- 4 Payments on account

#### II Tangible assets

- 1 Land and buildings
- 2 Plant and machinery
- 3 Fixtures, fittings, tools and equipment
- 4 Payments on account and assets in course of construction

#### III Investments

- 1 Shares in group undertakings
- 2 Loans to group undertakings
- 3 Participating interests<sup>11</sup>
- 4 Loans to undertakings in which the entity has a participating interest
- 5 Other investments other than loans
- 6 Other loans
- 7 [Own shares]<sup>12</sup>

### C Current assets

#### I Stocks

- 1 Raw materials and consumables
- 2 Work in progress
- 3 Finished goods and goods for resale
- 4 Payments on account

#### II Debtors<sup>13</sup>

- 1 Trade debtors
- 2 Amounts owed by group undertakings
- 3 Amounts owed by undertakings in which the entity has a participating interest
- 4 Other debtors
- 5 Called up share capital not paid<sup>10</sup>
- 6 Prepayments and accrued income<sup>14</sup>

<sup>10</sup>May be presented either at position A or at position C.II.5.

<sup>11</sup>In group accounts when the group has an investment in an associate or joint venture, replace this heading with two headings: 'Interests in associated undertakings' (being the associate and/or joint venture) and 'Other participating interests'.

<sup>12</sup>Own shares held are deducted from reserves under FRS 101 and FRS 102 rather than being shown as an investment.

<sup>13</sup>The amount falling due after more than one year is shown separately for each item included under debtors. Under FRS 102, if the aggregate balance due after more than one year is sufficiently material it is disclosed on the face of the balance sheet within current assets; otherwise it is disclosed in the notes.

<sup>14</sup>May be presented either at position C.II.6 or at position D.

**III Investments**

- 1 Shares in group undertakings
- 2 [Own shares]<sup>12</sup>
- 3 Other investments

**IV Cash at bank and in hand****D Prepayments and accrued income<sup>14</sup>****E Creditors: amounts falling due within one year**

- 1 Debenture loans<sup>15</sup>
- 2 Bank loans and overdrafts
- 3 Payments received on account
- 4 Trade creditors
- 5 Bills of exchange payable
- 6 Amounts owed to group undertakings
- 7 Amounts owed to undertakings in which the entity has a participating interest
- 8 Other creditors including taxation and social security<sup>16</sup>
- 9 Accruals and deferred income<sup>17</sup>

**F Net current assets (liabilities)<sup>18</sup>****G Total assets less current liabilities****H Creditors: amounts falling due after more than one year**

- 1 Debenture loans<sup>15</sup>
- 2 Bank loans and overdrafts
- 3 Payments received on account
- 4 Trade creditors
- 5 Bills of exchange payable
- 6 Amounts owed to group undertakings
- 7 Amounts owed to undertakings in which the entity has a participating interest
- 8 Other creditors including taxation and social security<sup>16</sup>
- 9 Accruals and deferred income<sup>17</sup>

**I Provisions for liabilities**

- 1 Pensions and similar obligations
- 2 Taxation, including deferred taxation
- 3 Other provisions

**J Accruals and deferred income<sup>17</sup>****K Capital and reserves**

<sup>15</sup>The amount relating to any convertible loans is shown separately.

<sup>16</sup>The amount for creditors in respect of taxation and social security is shown separately from the amount for other creditors.

<sup>17</sup>May be presented either at positions E.9 and H.9 (as appropriate) or at position J.

<sup>18</sup>The amount shown for net current assets/liabilities takes into account the amount of prepayments and accrued income, wherever that amount is presented.

<sup>19</sup>The amount of allotted share capital and the amount of called up share capital which has been paid up are shown separately.

- I Called up share capital<sup>19</sup>
- II Share premium account
- III Revaluation reserve
- IV Other reserves
  - 1 Capital redemption reserve
  - 2 Reserve for own shares
  - 3 Reserves provided for by the articles of association
  - 4 Other reserves
- V Profit and loss account

### ***Non-controlling interests***<sup>6</sup>

#### **Notes to formats**

The heading or sub-heading for any item does not have to be distinguished by any letter or number assigned to that item. The headings and sub-headings in bold text (including those in blue text) above are shown on the face of the profit and loss account or balance sheet as applicable. Items to which Arabic numbers are given (e.g. 1, 2 – in plain text above) may be presented either on the face of the profit and loss account or balance sheet, or in the notes to the accounts. Items in italics above apply only to group accounts.

All items are shown in the order, and under the headings and sub-headings, given. However:

- Headings or sub-headings are not used if there is no amount to be shown for that item for both the current and preceding financial period.
- When the special nature of the entity's business requires it, the arrangement, headings and sub-headings otherwise required in respect of items given an Arabic number (e.g. 1, 2 – in plain text above) in the balance sheet or profit and loss account format used are adapted.
- Any item required to be shown in an entity's balance sheet or profit and loss account may be shown in greater detail than required by the particular format used.
- An entity may adapt the balance sheet and/or profit and loss account formats so to distinguish between current and non-current items in a different way, provided that:
  - the information given is at least equivalent to that which would have been required by the use of such format had it not been thus adapted, and
  - the presentation of those items is in accordance with generally accepted accounting principles or practice.

The formats used are consistent from period to period unless, in the opinion of the company's directors<sup>20</sup>, there are special reasons for a change. Particulars of, and the reasons for, any such change are given in a note to the accounts in which the new format is first used.

The detailed note disclosure requirements of the Regulations are not reproduced here. The full text of SI 2008/410 is available at: [http://www.legislation.gov.uk/ukxi/2008/410/pdfs/ukxi\\_20080410\\_en.pdf](http://www.legislation.gov.uk/ukxi/2008/410/pdfs/ukxi_20080410_en.pdf).


With effect from periods beginning on or after 1 January 2016 (early-adoption is permitted as discussed in paragraph INT.7 of this publication), the Regulations are amended by SI 2015/980. These changes are annotated in the profit and loss account and balance sheet formats reproduced in this appendix. In addition to these small changes to the formats:

- The profit and loss account and balance sheet formats may be adapted so as to distinguish between current and non-current items in a different way, provided that the presentation of those items is in accordance with GAAP, and that the information given is at least equivalent to that which would have been required, had a revised format not been presented.
- Formats 3 and 4 for the profit and loss account are removed from the Regulations.

The full text of SI 2015/980 is available at: [http://www.legislation.gov.uk/ukxi/2015/980/pdfs/ukxi\\_20150980\\_en.pdf](http://www.legislation.gov.uk/ukxi/2015/980/pdfs/ukxi_20150980_en.pdf)

<sup>20</sup>Or equivalent for non-companies.





Interpretative guidance is based on specific facts and circumstances. In many instances, further interpretation will be needed in order for an entity to apply FRSs 100, 101 and 102 (including, when relevant, FRS 103) to its own facts, circumstances and individual transactions. Further, some of the information contained in this publication is based on the interpretations of KPMG in the UK's Department of Professional Practice, which may change as practice and implementation guidance develop. Users are cautioned to read this publication in conjunction with the actual text of the standards and implementation guidance issued, and to consult their professional advisers before concluding on accounting treatments for their own transactions.

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