The Future of UK GAAP

International Financial Reporting Standards

November 2012

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Chartered Accountants & Business Advisers

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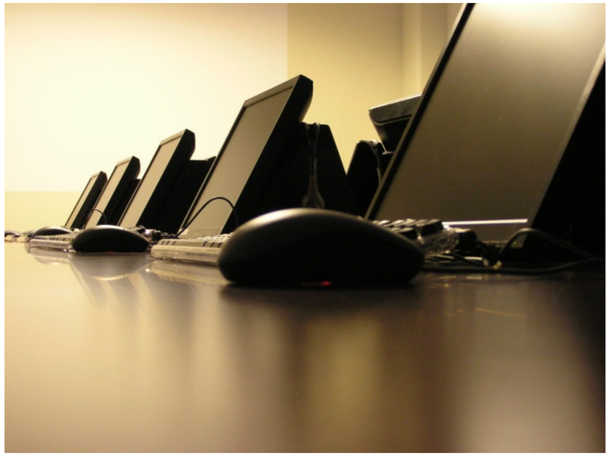
Appendices

- **Major changes** are currently being made to **UK accounting standards** which will impact the way companies prepare their annual financial statements

- These new standards are expected to be issued by the **end of 2012** and will be mandatory for periods ending **31 December 2015**, therefore, opening balance sheets at **31 December 2013** will be required under the new standards

- For some companies there may be **benefits** to adopting these standards **earlier** than the **mandatory date**

- **Clive Owen & Co LLP** are here to **advise and support** you through this process of change



Current UK accounting standards

Currently in the UK only entities listed on a regulated market – i.e. the London Stock Exchange (LSE) or the Alternative Investment Market (AIM) - are required to file their accounts in accordance with International Financial Reporting Standards (IFRS).

All other UK Companies, for their consolidated financial statements, are permitted to use IFRSs or to follow the accounting principles established by the United Kingdom Accounting Standards Board (UK GAAP), as follows:

- Financial Reporting Standards (FRS) issued by the UK Accounting Standards Board (ASB).
- Statements of Standard Accounting Practice (SSAPs) adopted by the UK Accounting Standards Board.
- UITF Abstracts issued by the Urgent Issues Task Force (UITF) of the UK Accounting Standards Board.
- Financial Reporting Standard for Smaller Entities (FRSSE), which gives some exemptions from applying all other accounting standards, for small companies only.

Planned transition to IFRS

In August 2009 the ASB published for consultation a policy proposal on convergence with IFRS.

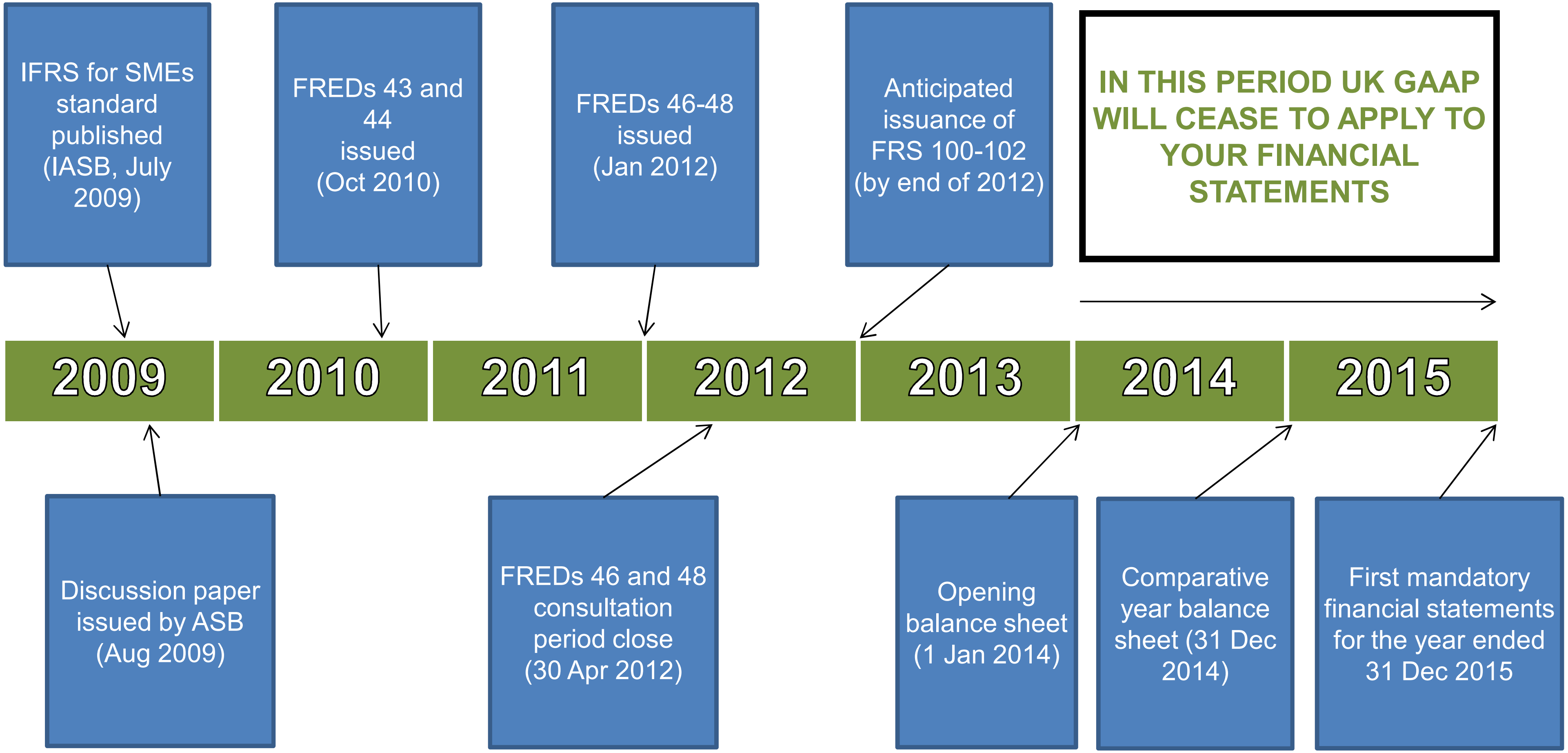
There have been a series of consultation periods over the proposals as shown by the time line on the following page. During the consultation period financial reporting exposure drafts (FREDs) are released for comment. It now appears that the new standards will be issued by the end of this calendar year.

These standards will be called FRS 100, FRS 101 and FRS 102.

The first year end for which it will be **mandatory** to follow the new standards will be **31 December 2015**. From this date onwards **UK GAAP**, excluding the FRSSE, will **cease to exist as an accounting concept to apply**.

Early adoption will be permitted under the standards if an organisation decides it is in their interests to switch earlier than this date.

Anticipated timetable



Outline of the new standards

The three new standards will replace all current UK accounting standards. The purpose of each is as follows:

- **FRS 100 (FRED 46)** sets out a proposed framework that would apply to all UK entities preparing financial statements that are intended to give a true and fair view other than where an entity is required or chooses to prepare its financial statements in accordance with IFRSs or the FRSSE.
- **FRS 101 (FRED 47)** is a proposed reduced disclosure framework for qualifying entities preparing their financial statements in accordance with IFRSs.
- **FRS 102 (FRED 48)** contains the text of a comprehensive proposed accounting standard based upon the International Financial Reporting Standard for Small and Medium-sized Entities, this would replace current UK GAAP.

The new standards will effectively allow for three different tiers of reporting in the UK, as explained opposite.

Impact of the new standards

Accounting tier	Applicable to	Example
IFRS	Those required to apply by law or regulation Optional for others	Group accounts of EU or AIM listed entities
FRS 102	Large and medium sized entities Optional for small entities	Parent company or subsidiary of a listed group Large and medium private companies
FRSSE	Small entities (see Appendix A)	Small private companies

Under IFRS and FRS 102 there is also the option of reduced disclosures for 'qualifying entities' (see next page).

Qualifying entities

To qualify as a ‘qualifying entity’ the following criteria must be met:

- “A member of a group that prepares publicly available financial statements, which give a true and fair view, in which that member is consolidated.”
- Individual financial statements only.
- Includes parent entities.
- Shareholders must be notified (and can object to reduced disclosures).

It is the same definition for qualifying entities reporting under either IFRS with reduced disclosures or FRS 102.

However, the exemptions given under each of these are different (details of the exemptions are included in Appendix B).

How will this impact on my business?

How this will impact you depends largely on the size of your business.

If you currently qualify as a small entity then you are not required to make any changes, you can continue to adopt the FRSSE (although minor changes will be made to the FRSSE to align it with FRS 102 such as the default life for goodwill being set at 5 years rather than the current 20 years).

If you are currently a non listed business but do not qualify as a small company then you will need to apply FRS 102.

If you are a listed business then you will continue to apply full IFRS.

Entities can choose to adopt a higher level if they wish for example a small company could adopt FRS 102 if they felt there were benefits to it of doing so.

Is this relevant to me now?

We don't need to transition until 2014/15, so why do we need to think about this now?

Will it really be that difficult for us to transition across from UK GAAP?

The above are common thoughts of business owners when they are presented with this change. However, even if organisations wait until the latest possible date to transition and they have very few GAAP differences they still need to start planning for some of the important decisions they will need to make such as:

- Should the new UK standard be adopted or full IFRS?
- What should be done now to prepare for or understand the impact?
- What are the wider business considerations e.g. covenant reporting, cash tax payable?
- Are there any advantages of moving to IFRS before 2014/15?

Experience has shown the more work done in advance the easier the transition to IFRS.

Which option to choose?

There are a number of areas organisations should consider before deciding on which GAAP to use, such as the following:

- **Impact of GAAP differences on** (covered in further detail over the following pages):
    - Taxation impacts
    - Covenants
    - Distributable reserves/bonuses/profit sharing plans
- **Strategic plans** i.e. will the company move tiers as a result of growth, an acquisition, listing the business in the near future?
- **First time adoption/transition related opportunities** – are there benefits from accounting entries required at transition?
- **Accounting policies** – is one GAAP more closely aligned to your current accounting policies?
- **Peer company comparison** – what GAAP would you expect your competitors to report under?
- **Internal resources** – do you have the knowledge and capacity in your company to account under more complex GAAP?
- **Other reporting requirements** – do you need to report under full IFRS to your group?
- **Future changes to new UK standards** – how will these be amended in line with changes to IFRS in the future?

Tax implications

The starting point for calculating corporation tax is profit as recorded in the entity financial statements.

Therefore consideration should be given to areas where the tax treatment of items follows the accounting treatment which could give rise to unavoidable cash tax impacts. This should be assessed for each GAAP difference.

An example of this is in relation to lease incentives included within operating leases. UK GAAP requires incentives to be spread evenly over the period to the first break clause in the lease. Under IFRS (IAS 17) and FRS 102 the incentive would be spread over the entire lease term.

Potential cash tax advantages may arise over the incentive being spread over a longer term and also the falling rate of UK Corporation Tax in future years may also lead to further benefits (see Appendix C for a worked example of potential tax advantages).

Distributable reserves

Any change in GAAP accounting could lead to changes in the level of distributable reserves. One of the most significant changes in respect of this could be due to the multi employer exemption for defined benefit pension schemes not existing under IFRS or FRS 102.

This should be considered in advance to determine if it has any impact on remuneration strategy or shareholder return.

Profit reporting

GAAP differences could give rise to different levels of reported profits post transition. This could impact on any financial measures based on annual financial statements such as covenant reporting, calculation for ‘earn-out’ consideration or employee bonus schemes.

Consideration should be given to rebasing any financial measures which could be impacted in advance to avoid subsequent penalties or disputes.

UK GAAP vs. IFRS key differences

- **Goodwill** – no amortisation under IFRS, annual impairment test instead.
- **Negative goodwill** – not capitalised under IFRS (BUT will be if IFRS is followed with FRS 101).
- **Tangible fixed assets** – formal reviews of useful economic lives, residual values and depreciation methods required.
- **Borrowing costs and development costs** – if criteria are met then must be capitalised under IFRS, optional under UK GAAP.
- **Deferred tax** – balance sheet/temporary difference approach under IFRS.
- **Holiday pay accrual** – must be recognised under IFRS.
- **Leases** – spread incentives over entire lease term under IFRS.
- **Pensions** – group plans are not treated as multi-employer schemes under IFRS, must be on one company balance sheet.
- **Financial instruments** – recognition of derivatives under IFRS (only recognised under UK GAAP if FRS 26 adopted).
- **Business combinations** – potential recognition of more intangibles, all transaction costs expensed, merger accounting not permitted (other than for those under common control).
- **Foreign currency** – more guidance on functional currencies under IFRS.

UK GAAP vs. FRS 102 key differences

- **Goodwill** – five year default for amortisation under FRS 102 versus twenty years under UK GAAP.
- **Tangible fixed assets** – formal reviews of useful economic lives, residual values and depreciation methods required
- **Deferred tax** – 'timing differences plus' approach under FRS 102.
- **Holiday pay accrual** – must be recognised under FRS 102.
- **Leases** – spread incentives over entire lease term under FRS 102.
- **Pensions** – group plans are not treated as multi-employer schemes under FRS 102, must be on one company balance sheet.
- **Financial instruments** – simplified form of IAS 39/IFRS 9 (or policy choice to adopt IAS 39).
- **Business combinations** – potential recognition of more intangibles, merger accounting not permitted (other than for those under common control).

See Appendix D for more detail on the differences between the three GAAPs.

Expertise, understanding and knowledge

We are available to assist in a variety of different ways as your organisation prepares for its transition away from UK GAAP.

This can take many different forms from ‘on-call’ advisory advice to full IFRS conversion, including impact assessment, assistance in calculation of GAAP differences, drafting of skeleton accounts.

If you are interested in discussing this further with us then please do not hesitate to contact your normal Clive Owen & Co LLP contact.

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To qualify as small the company must not exceed two of the criteria shown below in the current and preceding year, except that the exemption may be retained in the first year in which the criteria are exceeded(CA 06 s.382(3))(SI 2008.393):

- Aggregate turnover £6.5m.
- Aggregate balance sheet total £3.26m.
- Aggregate number of employees 50.

A parent company only qualifies as small if the group it heads is a small group.

Where the period is not a year the figures are to be adjusted proportionately (CA 06 s.382(4)).

FRS 101

FRS 101 allows certain exemptions from elements of the following IFRS accounting standards providing sufficient detail is given in the consolidated financial statements:

- IFRS 2 – share based payments
- IFRS 3 – business combinations
- IFRS 5 – non-current assets held for resale and discontinued operations
- IFRS 7 – financial instruments: disclosures
- IFRS 13 – fair value measurement
- IAS 1 – presentation of financial information
- IAS 7 – statement of cash flows
- IAS 8 – accounting policies, changes in accounting estimates and errors
- IAS 16 – property plant and equipment
- IAS 24 – related party disclosures
- IAS 36 – impairment of assets
- IAS 38 – intangible assets

FRS 102

FRS 102 allows certain exemptions from disclosure requirements in the accounting standard providing sufficient detail is given in the consolidated financial statements:

- Section 7 statement of cash flows
- Section 3 financial statement presentation
- Section 11 basic financial instruments
- Section 12 other financial instrument issues
- Section 17 property plant and equipment
- Section 18 intangible assets other than goodwill
- Section 26 share based payments
- Section 33 related party disclosures

A company enters a 7 year lease on 1 April 2011. The annual rent is £420k, with the first year rent free and a break clause after 3 years. Under UK GAAP, the rent free period is spread over the first 3 years to the date of the first break. Therefore a charge of £280k per annum in years 1 to 3 followed by £420k per annum there after.

Under IFRS it would be spread over the entire lease, therefore a charge of £360k per annum:

	11/12 Yr 1 £'000	12/13 Yr 2 £'000	13/14 Yr 3 £'000	14/15 Yr 4 £'000	15/16 Yr 5 £'000	16/17 Yr 6 £'000	17/18 Yr 7 £'000	Total £'000
Tax rate	26%	24%	23%	22%	22%	22%	22%	
UK GAAP Rent charge	280	280	280	420	420	420	420	**2,520**
UK GAAP Tax deduction	72.8	67.2	64.4	92.4	92.4	92.4	92.4	**574**
IFRS Rent charge	360	360	360	360	360	360	360	**2,520**
IFRS Tax deduction	93.6	86.4	82.8	79.2	79.2	79.2	79.2	**580**

Increased tax deduction in first 3 years with no greater cash outflow.

On conversion to IFRS from 1 April 2013, £160,000 of the rent free period will need to be spread over the last 4 years of the lease, resulting in a reduction to opening reserves of £160,000 which will be deductible for tax purposes in the year to 31 March 2014.

£160,000 may then be taxed over the next 4 years as it is released to profit or loss.

This gives a benefit due to the changing tax rates at the different points of the charge and release being taxed together with a cash flow benefit.

	11/12 Yr 1 £'000	12/13 Yr 2 £'000	13/14 Yr 3 £'000	14/15 Yr 4 £'000	15/16 Yr 5 £'000	16/17 Yr 6 £'000	17/18 Yr 7 £'000	Total £'000
Tax rate	26%	24%	23%	22%	22%	22%	22%	
Rent charge UK GAAP then IFRS	280	280	360	360	360	360	360	**2,360**
IFRS conversion opening reserves adjustment			160					**160**
Total Income statement charge								**2,520**
Tax deduction	72.8	67.2	119.6	79.2	79.2	79.2	79.2	**576**
Additional tax deduction upon conversion			55.2					**55**
Additional tax paid following conversion				(13.2)	(13.2)	(13.2)	(13.2)	**(53)**
Net tax saving								**2**

EU adopted IFRS	FRS 102	UK GAAP
Business combinations and consolidation		
► Focus on ability to control	► Same as IFRS	► Focus on whether control is exercised
► Common control transaction are scoped out	► Same as IFRS	► Includes guidance on group reconstructions
► Purchase method approach	► Purchase method approach	► Acquisition accounting using cost approach ► Merger accounting permitted
► Transaction costs expensed	► Transaction costs capitalised	► Same as FRS 102
► Subsequent adjustments to contingent consideration taken to profit	► Contingent consideration adjusted to goodwill	► Same as FRS 102
► Requires recognition of all intangible assets that are identifiable and measurable	► Same as IFRS	► Require intangible assets to be separable for recognition, hence fewer intangible assets recognised
Joint ventures and associates (IFRS applicable as at 31/12/2011)		
► In group accounts ► Equity accounting for associates ► Permits equity accounting or proportionate consolidation for jointly controlled entities (JCEs)	► Requires equity accounting method for JCEs and associates in group accounts	► Similar to IFRS. 'Gross equity' accounting required for JVs
► Cost accounting required for associates and JCEs in investor individual accounts	► Cost model or fair value in investor's financial statements	► Cost or valuation used in investor's financial statements

EU adopted IFRS	FRS 102	UK GAAP
Goodwill and intangible assets (including R&D)		
▸ Goodwill not amortised – indefinite life asset subject to annual impairment reviews	▸ Goodwill treated as a finite life asset – amortised over useful life ▸ Default life is 5 years unless the goodwill has a longer useful life	▸ Goodwill treated as finite life asset and amortised – deemed 20 yr maximum life ▸ Permits indefinite life or longer lives subject to annual impairment reviews
▸ Negative goodwill is not capitalised [different under FRS 101]	▸ Negative goodwill recognised in profit over period which the non-monetary assets acquired recovered	▸ Same as FRS 102
▸ Development expenditure must be capitalised if certain criteria are met	▸ Capitalisation of development expenditure is to be permitted	▸ Option to capitalise development expenditure that meets certain criteria ▸ An internally developed intangible asset may be capitalised only if it has a readily ascertainable market value
Tangible fixed assets		
▸ Allows cost or revaluation model (through equity)	▸ Allows cost or revaluation model (through equity)	▸ Same as IFRS
▸ Residual values must be revalued to current prices each year	▸ Same as IFRS	▸ Residual values retained at acquisition prices
▸ Componentisation required at the material parts level	▸ Same as IFRS	▸ Similar to IFRS but less stringent requirements
▸ Formal annual review of useful lives and depreciation methods required	▸ Same as IFRS	▸ Similar to IFRS but commonly not formally performed in practice

EU adopted IFRS	FRS 102	UK GAAP
Financial Instruments		
▶ Based on the classification criteria, financial assets and liabilities are valued based on either: ▶ Amortised cost ▶ At fair value	▶ Option to adopt IAS 39 (IFRS) or FRS 102 equivalent ▶ FR S 102 equivalent is a simplified version of IFRS: ▶ No available for sale financial assets	▶ Companies who have adopted FRS 26: ▶ Same as IFRS ▶ Companies who do not adopt FRS 26: ▶ No fair value accounting applied for financial instruments
▶ Derivatives and some embedded derivatives are recognised and measured at fair value ▶ Complex hedge accounting rules apply	▶ No concept of embedded derivatives ▶ Hedge accounting rules simpler but use restricted	▶ No requirement to recognise derivative financial instruments (non-FRS26 adopters)
▶ Extensive disclosures	▶ Limited disclosures for all companies as set out in FRS 102	▶ Limited disclosures
Corporation taxes		
▶ Deferred taxation provided for using a balance sheet/temporary difference approach	▶ “Timing differences plus” approach	▶ Deferred taxation provided for using a profit and loss account/timing difference approach

EU adopted IFRS	FRS 102	UK GAAP
Employee benefits (IFRS as at 31/12/2011)		
▸ Net liability approach using projected salaries	▸ Net liability approach based on present value of future obligations ▸ Simplification of calculation allowed (e.g. ignore future salary increases)	▸ Same as IFRS
▸ Past service costs from unvested benefits are recognised on a straight-line basis over the average period until benefits vest	▸ No deferral of past service costs – recognised immediately	▸ Same as IFRS
▸ Actuarial gains and losses can be recognised immediately in profit or other comprehensive income (OCI), or deferred using the corridor approach	▸ All actuarial gains and losses recognised immediately only in OCI	▸ Actuarial gains and losses are recognised immediately through the STRGL
▸ Holiday pay must be accrued for	▸ Same as IFRS	▸ No formal requirement to accrue for holiday pay