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Update

Are you ready for the new financial reporting regime?

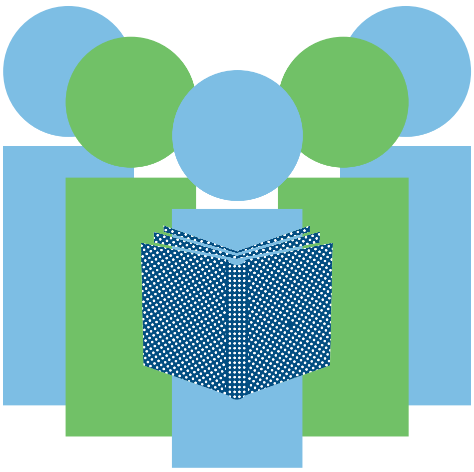
An introduction to the new UK GAAP framework

> Users of the existing FRSs and SSAPs will have to change their financial reporting framework.

The financial reporting landscape in the UK and Republic of Ireland (ROI) looks very different following the publication of four new accounting standards by the Financial Reporting Council (FRC) and so could your accounts!

Users of the existing Financial Reporting Standards (FRSs) and Statements of Standard Accounting Practice (SSAPs) will have to change their financial reporting framework, and prepare and plan for the change; small companies may yet have to follow suit and even International Financial Reporting Standards (IFRS) users may have a chance to think again.

This Update outlines the changes and highlights the decisions and potential actions that you will need to take in order to minimise the impact of unexpected and avoidable consequences. At the very least you will need to get used to using new terminology, but read on to see if there could be a more significant impact on your business.



Did you take out an interest rate swap agreement?

Under current UK accounting rules, it is usual to account for an interest rate swap agreement as a series of payments based on the net interest impact of the swap, usually on a six monthly settlement basis.

Under new UK GAAP, in addition to the above it will be necessary to estimate the fair value of financial instruments such as swap agreements, to include their fair values in your balance sheet, and to include any annual change in those values in the profit and loss account.

With interest rates low, most swap agreements are burdensome, with net payments being made by companies to banks at every settlement date. Accordingly, in future you will include your best estimate of the net present value of all future liabilities under swap contracts as a liability in your accounts. You may well be aware of this figure if you have asked or been advised by your bank about the break cost of your agreements.

This has significant consequences. Firstly, while the swap agreement is onerous, the additional liability will reduce your net asset value and may affect any bank covenants accordingly. Secondly, the profit or loss for the year will be affected annually by any change in the fair value of the swap. Even if interest rates remain unchanged, getting nearer to the end of the swap agreement will make it less of a liability, and will therefore create a gain included in the profit and loss account each year until the swap contract comes to an end.

In future, when interest rates begin to vary again, it may be that the revaluation will in some years give a gain and in others a loss; each of which will have to be recognised. You will, therefore, find that contracts that were intended to manage your risk have the effect of introducing volatility to your profit and loss account.

Of more immediate concern is the possibility that amounts payable under bonus arrangements, management agreements and other contracts could be changed by these new accounting rules. As a result, it would be wise to review the wording of any agreements that refer to the profit for the year or to the total costs incurred and to consider whether these need to be renegotiated in some way.

Does your company enter into forward foreign currency contracts, or other financial instruments?

The rules described above for interest rate swap agreements are in fact general rules, which are to be applied to all financial instruments (other than basic contracts: cash, loans receivable and payable and most investments in shares) including forward foreign currency contracts.

Imagine a company that buys foreign exchange a long period forward so as to manage its cost risks. Ordinarily we would account under current UK GAAP for the purchase of the currency at the time of settlement, with the effect that our new stock or new machinery will be brought into the books at the contracted rate.

Under the new rules, any such contract that was entered into before the balance sheet date would have to be revalued at the balance sheet date, creating a gain or loss to be included in the profit and loss account. If your company has significant forward purchases (or sales) of currency, or you are investing in or managing your risks by way of derivative financial instruments, you will need to consider carefully the impact that recognising these unrealised gains or losses annually will have on your financial statements and could have on the readers of your accounts.

The new accounting standard does include detailed hedging rules, by which derivative transactions that are intended to hedge a risk can be accounted for so as to match the accounting for the underlying transactions. The rules are reasonable, but they do require that hedging documentation is put in place prior to the inception of a transaction that is to be accounted for as a hedge. Hedge accounting itself is a choice, so you will have to make decisions about whether to accept greater profit and loss volatility or whether to accept the administrative effort of formal hedge accounting arrangements.

Does your balance sheet include any revalued property or other assets?

New UK GAAP includes a requirement to provide for deferred tax on any revaluation gain, whereas under existing UK rules the deferred tax is accounted for only after a company has entered a binding contract to sell the property. For example, if a property has been revalued by £1 million and under applicable legislation the profit on disposal would be taxed at 20%, the company would need to make a provision of £200,000 for the tax payable on a hypothetical sale, regardless of the company's intentions for the property.

The point here is the reduction in the net asset value of the balance sheet by £200,000. This may even put the company's compliance with its borrowing covenants at risk. If you are a company with significant loan covenants and revalued property you may well need to discuss those covenants with your bank in order that they can be rewritten before a breach is generated by the change to new accounting rules.

…Mine does, because investment property is my business!

Investment property companies revalue their investment property every year and will therefore suffer the deferred tax charge and the net asset reduction described above.

However, there is more! Under the new rules, the gain or loss determined in the annual revaluation is recognised in the profit and loss account, which could introduce not only volatility but also gains and losses out of all proportion to net rental income and the usual property expenses. Consequently, any bonus or profit-sharing arrangements and any covenants based on profit and loss account ratios will be affected, potentially dramatically so, when shifting to the new system of accounting.

Accordingly, it is particularly important for investment property companies to also review any agreements which refer to the company's profit or loss for the year for their effect.

Is yours an acquisitive business?

Under the new UK accounting rules, goodwill arising on an acquisition will have to be written off over its estimated useful life whenever a useful life can be estimated reliably. So far, so reasonable. However, in a dramatic change to past practice it is currently suggested that where no reliable estimate of useful life can be made the maximum permitted useful life will be just five years; accordingly, future goodwill will often be amortised at a rate of 20%, leading to significant short term reductions in profit. (Note though that there is currently some discussion about relaxing this cap to ten years.)

New UK GAAP also falls into line with IFRS in taking away the option for merger accounting to be applied to the business combination of previously independent, roughly equal sized businesses. In future, merger accounting will be permitted only for public benefit entities and restructuring arrangements involving businesses under common control, provided any company law or similar constraints are also met.

Could your accounting profit and balance sheet be changed by other new accounting rules?

Apart from the major changes discussed in this Update, there are numerous other differences between the new UK standard and its predecessors, for example:

- it will become compulsory to make an accrual for holiday entitlements that are carried forward at the accounting year end;
- it will often be necessary to account differently for loan costs, and even for the notional interest on long term interest free loans such as are often made between group companies or by shareholders;
- the useful economic lives of intangible assets are to be capped in line with the new goodwill rules;
- each company in a group will have to account for its proportionate share of the deficit and liability of a group defined benefit pension scheme, unless there is neither policy nor contract to this effect, in which case the entire deficit will have to be accounted for by the company which is legally responsible for the plan; and
- accounting rules are introduced for agriculture.

It is possible that large numbers of companies will not have to apply any different accounting rules to their transactions and accordingly these companies will not see any material change to their numbers. Nevertheless, it would be wise for any company to review or to arrange a review of the possible impact of new UK GAAP on its accounts.

Will you have to pay more tax?

The tax treatment of profits and losses generally follows the accounting treatment unless there is specific tax legislation to require otherwise. Any changes in accounting policies arising from implementing FRS 102 may also lead to tax charges specifically in respect of any consequent prior year adjustments.

Gains and losses on changes in property values are only taxed when the property is sold. Therefore, no tax will be charged on revaluation gains on investment properties even though these are included in the profit and loss account. In contrast, the gains and losses introduced by the need to fair value financial instruments may be taxable.

Our tax specialists can help you review your current situation and assist you in determining the best route for you to take in your preparation for the change.

Will your accounts actually look different?

The format and layout of the cash flow statement is being changed to match the version in IFRS. We are encouraged to adopt new language and to prepare an income statement where we previously would have had a profit and loss account, and a statement of financial position where we previously had a balance sheet, although the name changes are not mandatory. There are other tweaks to the layout including a requirement to show a statement of changes in equity as a primary statement.

One potentially important point to make is that a liability can only be classified in a balance sheet as long-term if that was contractually the case prior to the year end.

Are companies that presently apply IFRS able to ignore the changes?

The Companies Act is unamended, so that the generality of companies continue to have a choice between EU-adopted IFRS and UK GAAP. The legal obligation to use EU-adopted IFRS only applies (as at present) to consolidated financial statements of entities listed on a regulated market in the EU. Other markets may, by their own regulations, require participant companies to apply EU-adopted IFRS, for example, it is well known that the Alternative Investment Market (AIM) does so.

If your business is currently required or elects to apply EU-adopted IFRS you can continue to do so with no change to your reporting requirements.

If your business has adopted IFRS voluntarily, you could find the possibility of adopting FRS 102 appealing. The recognition and measurement criteria of FRS 102 are very much in line with IFRS, but FRS 102 is much briefer and easier to apply. Recent changes to the Companies Act also make it easier to revert to UK GAAP from IFRS.

Are there any special rules for subsidiaries?

The new regime also includes a standard, FRS 101: the Reduced Disclosure Framework, which, subject to certain qualifying conditions, allows subsidiaries to adopt IFRS principles with exemptions from a number of the more onerous IFRS disclosure obligations. The objective of this standard is to reduce the administrative burden of preparing the annual accounts, which could be attractive, particularly to a new, qualifying company that has not established the systems it needs to prepare full IFRS accounts.

However, there are complexities within FRS 101 that require detailed consideration, and indeed further developments in the standard are already being considered. For more details on the Reduced Disclosure Framework, please refer to our technical release on FRS 101, which can be viewed on our website at: **www.uhy-uk.com/resources/publications/frs-101**, or to your usual UHY contact.

FRS 102 similarly includes some disclosure exemptions for subsidiaries. Both standards, for example, exempt the qualifying subsidiary from preparing a cash flow statement.

Of course any subsidiary company will have to have regard to the wishes of its parent. You should also note that in order to be able to take advantage of these reduced disclosures (whether adopting the framework of FRS 101 or taking the exemptions permitted by FRS 102), all shareholders must be notified in writing and they must not have objected, after having been given reasonable opportunity to do so.

So what is new UK GAAP in a nutshell?

The new accounting standards are:

- FRS 100 Application of Financial Reporting Requirements;
an over-arching standard, explaining which standards apply to which types of entities, when the reduced disclosure framework can be applied, and when an entity should follow a SORP.
- FRS 101 Reduced Disclosure Framework;
as discussed above, allows subsidiaries to adopt IFRS principles with exemptions from a number of the more onerous obligations, subject to certain qualifying conditions.
- FRS 102 The Financial Reporting Standard Applicable in the UK and Republic of Ireland;
the individual accounting changes discussed in the Update contrast FRS 102 with existing UK GAAP and explain the key differences.
- FRS 103 Insurance Contracts;
permits insurance companies to continue with their present accounting practices pending the compilation of an IFRS on insurance accounting.

The highlights of the new regime are that:

- FRSs, SSAPs and Urgent Issue Task Force Abstracts (UITFs) that currently comprise UK GAAP are completely replaced by the new Standard, FRS 102;
- Statements of Recommended Practice (SORPs) have been updated or withdrawn as appropriate;
- the idea of the reduced disclosure framework for subsidiaries is firmly established; and
- the Financial Reporting Standard for Smaller Entities (FRSSE) (as amended in 2013 and 2014) will continue to be available for those entities that qualify to use it; although its future is currently under review by the FRC. (See "Stop Press!" below).

Choosing a financial reporting framework under the new regime

FRS 101 and FRS 102 represent major changes to financial reporting. The degree of change for your individual business will depend on your current accounting regime and the choices you make for your future reporting framework. You are likely to see the greatest impact if you are currently required or choose to report under UK GAAP.

For some businesses, important choices will need to be made. You should consider the advantages and disadvantages of all the permitted options, for example having regard to the effects on tax, distributable profits, possible future developments, parent company requirements and internal systems etc, before making a decision as to which regime to adopt. As always, we would be pleased to assist you with any such deliberation.

Small companies: Financial Reporting Standard for Smaller Entities 2015 and more

The long term future of the FRSSE is currently under review, with the potential changes described in the "Stop Press!" below. For now, however, the FRSSE will continue to be available for companies that qualify to use it.

There are three key changes between the latest FRSSE and the 2008 version:

1. The useful life of goodwill and intangible assets will be presumed to not exceed five years, where the entity is otherwise unable to make a reliable estimate of the useful life.
2. An entity will be required to assess, annually, whether there is an indication that any asset is impaired.
3. The definitions of 'related parties' and 'close family members' were updated.

The latest FRSSE is effective for periods beginning on or after 1 January 2015, with early adoption permitted.

FRS 102 – the new financial reporting standard for the UK and ROI

The new financial reporting standard, FRS 102, rewrites and updates our accounting rules and in a relatively brief and straightforward style brings them more into line with IFRS. The key changes are discussed in the body of this Update.

Certain topics from the full IFRS have also been added by way of a cross-reference, such as earnings per share or segmental information, as they are likely to be required only very occasionally and are to be applied in full when they are relevant.

As this new UK GAAP is intended to apply generally, and not just to companies, the new Standard has to be effective for the likes of public benefit entities, such as charities or educational institutions, retirement benefit plans and some financial institutions. Therefore, FRS 102 includes some accounting requirements specifically to reflect the diverse nature of organisations that will adopt it.

Stop Press! Micro-entities and a farewell to the FRSSE?

Following the latest EU Accounting Directive, the UK will be introducing an accounting regime for 'micro-entities' which, broadly speaking, are those that meet at least two of the following three conditions:

- turnover less than £632,000;
- total assets less than £316,000; and
- ten or fewer employees.

The FRC therefore proposes that it will, in due course, set out a "Financial Reporting Standard for Micro-Entities" (FRSME).

The existing FRSSE contains a number of requirements that are in excess of what will be permitted when the Accounting Directive is enacted and in consequence the FRSSE must be changed again. After reflection, and in particular bearing in mind the perceived simplicity of FRS 102, it is now proposed by the FRC that even the 2015 FRSSE will be abandoned and that small entities will therefore migrate to FRS 102. FRS 102 will itself be amended so as to be less onerous for qualifying small companies.

All being well, this comprehensive and, we think, welcome restatement of small (and micro) company financial reporting is expected to be in place for accounting periods beginning on or after 1 January 2016. Nevertheless, it should be stressed that final decisions on any accounting changes and their implementation dates are unlikely to be released until 2015.

The next step

If you are feeling bold and pick up a copy of FRS 102 you will instantly see a difference in the language used, but you should also recognise much from current UK GAAP. Whatever your reaction, don't be too hasty in judging whether you will or won't need to make changes. The process of moving from one GAAP to another is a complex one and should be considered from all angles including the effects of taxation, distributable profits and, where you are part of a group, the group's needs too.

For further information or to discuss the new UK GAAP in relation to your specific circumstances, please contact your usual UHY partner. Alternatively, you can read more about us on our website **www.uhy-uk.com**.

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