Tread carefully

Stephanie Henshaw highlights some of the major differences between current UK GAAP and the requirements of FRS 102

FRS 102 *The Financial Reporting Standard applicable in the UK and the Republic of Ireland* represents a significant change to the structure of UK accounting standards. It condenses existing UK accounting standards, incorporates new requirements and amends others. The resulting regime is not quite the same as existing UK GAAP, so preparers of financial statements will have to tread carefully in applying it for the first time.

The extent to which companies will have to restate their accounts under FRS 102 will depend on the nature and complexity of their operations, their assets and liabilities and the measurement methods they currently apply. Undoubtedly there will be some companies for whom the new standard does not create significant additional complexity. But others will need to get to grips with some technically demanding issues. Quite a bit of the early comment on FRS 102 has focused on the requirements in section 12 for complex financial instruments, and these are covered in Ken Rigelsford's article on pages 20-21. However, there are a number of other significant changes to measurement and recognition. This article summarises those major differences.

DEFERRED TAX

A potentially significant change for some companies is the requirement that deferred tax be recognised in respect of virtually all timing differences between taxable profit and total comprehensive income at the balance sheet date. This means that companies will now have to recognise deferred tax on revaluations of fixed assets and fair value adjustments on acquisition.

For companies who have adopted a policy of revaluation previously, this means bringing an additional deferred tax liability onto the balance sheet at transition and adjusting it year-on-year as the valuation is updated. The additional liability could significantly reduce a company's balance sheet total and retained reserves. Whether or not it also reduces distributable reserves will depend on the nature of the revalued asset.

Under current UK GAAP, significant long-term deferred tax liabilities might be mitigated by discounting them. There is no option to do so under FRS 102, and therefore any existing discounting will need to be reversed.

The impact of recognising the deferred tax arising on fair value adjustments on acquisition will depend on when the acquisition arose. For acquisitions under FRS 102, deferred tax will be adjusted via the goodwill on acquisition. Companies making acquisitions between their transition date and the date on which the first financial statements under FRS 102 are prepared will, therefore, need to consider the deferred tax impact of all fair value adjustments. However, deferred tax must also be provided on fair value adjustments that arose on pre-transition acquisitions, not as an adjustment to goodwill but as a reduction in reserves. This may also have implications for distributable profit.

INVESTMENT PROPERTIES

The normal measurement basis for investment properties will continue to be fair value, but under FRS 102 changes in fair value will be reported through the profit and loss account, not via the STRGL. Investment property companies – and other businesses that hold significant portfolios of investment properties – are therefore likely to see an increase in earnings volatility as a result.

The changes discussed above will mean deferred tax will need to be recognised on valuation adjustments. Investors may assume that any increase in reported profit will result in increased dividends, but this will not be the case where the increase arises solely as a result of valuation adjustments. As a general rule, neither changes to property valuation nor the related deferred tax are treated as realised for distribution purposes.

If there is 'undue cost and effort' associated with establishing the fair value of investment property, companies will be allowed to account for them at historic cost instead. However, the cost model requires depreciation to be provided on all tangible assets except land. A company that adopts the cost model for its investment property will, therefore, report reduced, post-depreciation profit. It should be noted that any additional depreciation charge will adversely affect the company's dividend-paying capacity.

There are other differences from current UK GAAP worth mentioning:

- Property let to and occupied by another group company is no longer excluded from the definition of investment property. Individual company accounts may need to be adjusted to take this into account, although changes will not affect the consolidated accounts of the group.
- Where an interest in investment property is held under an operating lease, FRS 102 permits classification as a finance lease on a property-by-property basis. At the moment, such properties are recognised as assets at their market value. Under FRS 102, both an asset and a related

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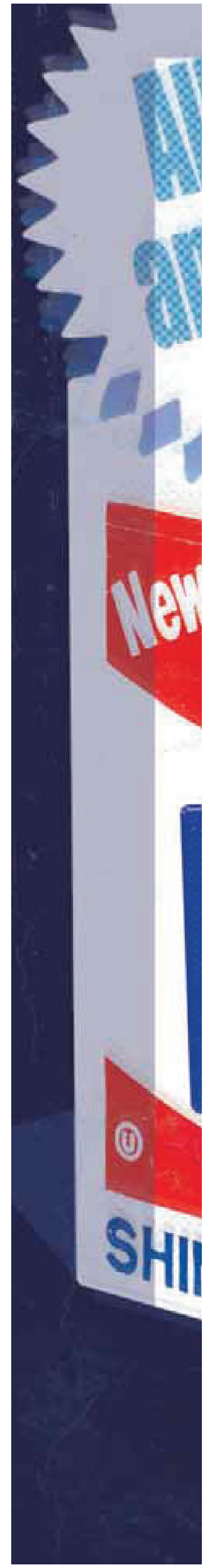

liability are recorded, using slightly different measurement principles.

USEFUL LIFE OF GOODWILL AND INTANGIBLES

Current UK GAAP requires goodwill and intangibles to be amortised over their estimated useful life, subject to a rebuttable presumption of a maximum life of 20 years or less. Under FRS 102, estimated useful life must not exceed five years, unless there is a reliable basis on which a longer life can be justified. Consequential amendments mean that this change will also affect entities adopting the FRSSE. For companies that currently have a robust basis for using a life in excess of five years, there will be no impact. But for a company that does not, a potentially significant adjustment will be required on transition, and higher future amortisation charges will result.

All intangibles and goodwill are deemed to have a finite life under FRS 102 and so there is no option to undertake annual impairment reviews instead of systematically amortising the asset over its useful life. For companies where the annual impairment review has not led to regular reductions in the carrying value of goodwill or intangibles, there could be a significant additional impact on reported profits (and dividend-paying capacity) from the switch to amortisation.

IDENTIFICATION OF INTANGIBLES ON ACQUISITION

Under current UK GAAP, goodwill arising on acquisition or consolidation is calculated as the difference between the fair value of the consideration given to acquire the business or investment and the fair value of the separable net assets acquired, where 'separable' means that they must be capable of being disposed of or settled separately from the underlying business. Consequently, some intangibles (such as operating licences, customer contracts etc.) are subsumed within goodwill. FRS 102 requires companies to consider the fair value of 'identifiable' net assets, and an intangible asset is deemed to be identifiable when either it is capable of being separated from the entity or it arises from contractual or other legal rights, regardless of whether those rights are transferrable or separable. Potentially this means that more intangibles are likely to be recognised separately from goodwill.

However, there is an important exception. Intangible assets acquired as part of a business combination will not be recognised separately when they arise from legal or contractual rights and a reliable fair value cannot be established. This is most likely to arise where there is no history or evidence of exchange transactions in similar assets and determining a fair value would depend on immeasurable variables. This means that intangibles will not always be recognised separately from goodwill as part of a business combination.

It is also worth noting that the transitional provisions of FRS 102 specifically state companies should not retrospectively separate from goodwill intangibles previously subsumed within it, unless they elect to apply section 19 in full to pre-transition aquisitions. This exemption only applies to business combinations before transition to FRS 102. For any business combination occurring after transition, separation will need to be considered. Companies planning an acquisition after transition but before the mandatory adoption date of FRS 102 will need to consider both the current and future recognition and measurement requirements so they can make the appropriate adjustments on transition.

DEFINED BENEFIT PENSION SCHEMES

Currently, companies recognise an expected return on plan assets (based on the average rate of return on assets held by the plan expected over the remaining life of the scheme) and an interest cost (reflecting the expected increase in the present value of the plan liabilities when the discount unwinds as the benefits get closer to settlement). In future, they will recognise net interest on

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the net defined benefit asset or liability during the reporting period. The effect of this change on pre- and post-tax profit could be significant, with reported profits being reduced in many cases.

Companies that belong to multi-employer schemes, where it is not possible to identify their share of the scheme's assets and liabilities, will continue to account for it as a defined contribution scheme. However, they will have to recognise a liability for committed deficit funding, rather than accounting for contributions only in the period in which they fall due, initially reducing net assets. Both the initial obligation and any subsequent changes to the liability will be recognised in profit or loss.

Under current UK GAAP companies that belong to a group defined benefit pension scheme have been exempt from the requirement to recognise their share of any deficit under the scheme, which is usually recognised only in the consolidated accounts of the group. However, under FRS 102, if there is a contractual agreement or stated policy for charging the scheme costs to individual members of the group, they will be required to recognise their share of those costs within their own accounts. If there is no such agreement or stated policy, the cost of the scheme is recognised in the accounts of the company that is legally responsible for it (which will often be the parent). As a deficit on a defined benefit scheme falls to be treated as a realised loss, there could be significant implications for a company's dividend-paying capacity if it is obliged to recognise that deficit. Therefore, companies will need to consider whether they should implement a contractual agreement or charging policy before their transition date and what impact that would have on each company's reserves.

HOLIDAY PAY ACCRUALS

FRS 102 requires companies to provide for all obligations to employees. One area of potentially significant change as a result is that of holiday pay.

Currently, many UK companies do not provide in their accounts for the cost of paid annual leave not taken at the year-end. In future they will be obliged to do so. While the financial impact may not be significant in all cases, there will be some companies where significant holiday pay accruals will have to be brought into the accounts, decreasing net assets and reserves, including profits available for distribution. The provision will have to be reviewed and adjusted via profit and loss year-on-year.

ACCOUNTING FOR CHANGES IN STAKE

Currently, when a parent company increases its stake in a subsidiary, the subsidiary's identifiable net assets are revalued to fair value, with a consequent adjustment to goodwill. Decreases in stake result in a gain or loss on disposal.

Under FRS 102, where a change in a parent company's stake does not result in a loss of control it is treated as a transaction with equity holders in their capacity as equity holders. This means there is no impact on profit or loss.

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