NEW UK FINANCIAL REPORTING STANDARDS
AN ICAS GUIDE FOR SMALL AND MICRO-ENTITIES
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1. **OVERVIEW OF THE NEW UK FINANCIAL REPORTING STRUCTURE**

Many firms will be in the process of assisting clients with the preparation of their first statutory accounts under new UK GAAP (i.e. in accordance with Financial Reporting Standard (FRS) 101, FRS 102, FRS 102 Section 1A or FRS 105). Whilst the new standards have been available for some time now, during 2015 there were a number of further changes to company law and accounting standards, mainly affecting small and micro-entities. The changes came in to effect for accounting periods beginning on or after 1 January 2016, with early adoption available for accounting periods beginning on or after 1 January 2015.

This guide aims to summarise the key points of the new structure (chiefly from the perspective of smaller entities), and to highlight the key focus areas and challenges in applying the new requirements.

**UK Financial Reporting Regime**

This consists of the following:

<table>
<thead>
<tr>
<th>Category</th>
<th>Accounting periods beginning on or after 1 January 2015</th>
<th>Accounting periods beginning on or after 1 January 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small entities</td>
<td>FRSSE (2015) or FRS 102 including section 1A - Small Entities</td>
<td>FRS 102 including section 1A - Small Entities</td>
</tr>
<tr>
<td>Other entities not required to apply IFRS (e.g. medium and large private companies)</td>
<td>FRS 102</td>
<td>FRS 102</td>
</tr>
<tr>
<td>Subsidiaries (and ultimate parent companies) of groups applying IFRS</td>
<td>FRS 101 reduced disclosure framework</td>
<td>FRS 101 reduced disclosure framework</td>
</tr>
<tr>
<td>Subsidiaries (and ultimate parents) of groups not applying IFRS</td>
<td>FRS 102 - Reduced disclosures for subsidiaries and ultimate parents</td>
<td>FRS 102 - Reduced disclosures for subsidiaries and ultimate parents</td>
</tr>
<tr>
<td>Companies listed on EU-regulated markets (consolidated accounts)</td>
<td>EU-endorsed IFRS</td>
<td>EU-endorsed IFRS</td>
</tr>
</tbody>
</table>

An entity may always opt to apply a more comprehensive standard, for example, a micro-entity may adopt FRS 102, or a large private company may adopt IFRS. The only exception to this is that charities are prohibited from adopting IFRS.
2. MICRO-ENTITIES REGIME

A micro-entity is a small company which also satisfies two of the following qualifying conditions:

- Turnover: Not more than £632,000.
- Balance sheet total: Not more than £316,000.
- Average number of employees: Not more than 10.

The turnover limit should be proportionately adjusted if the financial year is not 12 months. The usual two-year rule applies except in a company’s first financial year. Any type of entity which is excluded from the small companies regime cannot qualify as a micro-entity.

Furthermore, additional types of entity e.g. charities, investment undertakings, financial holding and insurance undertakings, credit institutions, overseas companies, unregistered companies and companies authorised to register pursuant to s1040 of the Companies Act 2006 are also specifically excluded.

If a company is a subsidiary undertaking and is included in consolidated group accounts by the method of full (as opposed to proportional) consolidation, then it cannot qualify as a micro-entity. A parent company can only qualify as a micro-entity for the purposes of its individual accounts if it qualifies as a micro-entity individually and the group headed by it qualifies as small. If a company is a parent company that prepares group accounts, then it cannot qualify as a micro-entity for the purposes of its individual accounts.

This regime was established in UK company law by the Micro-Entity Regulations 2013. The Limited Liability Partnerships (Accounts and Audit) Regulations 2016 extended the micro-entity regime to LLPs and qualifying partnerships that meet the qualifying criteria.

For accounting periods beginning on or after 1 January 2015, entities choosing to adopt the micro-entities regime have the option to use the FRSSE (2015), including the micro-entity amendments, or to adopt FRS 105. For accounting periods beginning on or after 1 January 2016, the FRSSE is withdrawn so all micro-entities wishing to take advantage of the reporting concessions available will require to use FRS 105.

The Financial Reporting Standard applicable to the micro-entities regime (FRS 105)

FRS 105 is a single financial reporting standard that applies to the preparation of individual financial statements of companies that qualify as micro-entities and choose to apply the Micro-entities Regime (also LLPs and qualifying partnerships). HMRC has confirmed that it will accept accounts prepared in accordance with FRS 105 for unincorporated entities meeting the size criteria for a micro-entity.

If transactions are not addressed by FRS 105 either directly or by cross reference to FRS 102, a micro-entity is not required to refer to FRS 102 in selecting its accounting policies. The recognition and measurement requirements in FRS 105 are broadly based on FRS 102, and amended to reflect the specific legal requirements for micro-entity accounts.

Key features of new standard

- All assets must be measured at cost - this means that property, plant and equipment and investment properties can only be measured at cost and previous revaluations gains would need to be removed on transition. Financial instruments cannot be measured at fair value, therefore are only measured at cost or amortised cost.
The only required disclosures (additional disclosures can be provided voluntarily) are:
- the total amount of any financial commitments, guarantees or contingencies that are not included in the balance sheet;
- an indication of the nature and form of any valuable security which has been provided;
- the amounts of advances and credits granted to members of the administrative, managerial and supervisory bodies with indications of interest rates, main conditions and any amounts repaid or written off or waived; and
- any commitments entered into on their behalf by way of guarantees of any kind, with an indication of the total for each category.

Accounts that comply with the minimal legal requirements are presumed to give a true and fair view.

There is no requirement to account for deferred tax and equity-settled share-based payments.

There are no accounting policy choices. All such choices have been removed, including the options to capitalise development costs and borrowing costs.

**True and fair view**

The financial statements of a micro-entity prepared in accordance with FRS 105 that include the micro-entity minimum accounting items are presumed in law to show a true and fair view of the micro-entity’s financial position and profit or loss in accordance with the micro-entities regime. FRS 105 permits, but does not require, a micro-entity to include information additional to the micro-entity minimum accounting items in its financial statements. If a micro-entity includes additional information it shall have regard to any requirement of Section 1A Small Entities of FRS 102 that relates to that information.

In the absence of a requirement in FRS 105 that applies specifically to a transaction or other event or condition, paragraph 8.4 of the standard provides guidance for making a judgement and paragraph 8.5 requires a micro-entity to look to the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles set out in section 2 of the standard.

**Choice of accounting regime**

Eligible entities should make a careful assessment of whether adopting the micro-entities regime and FRS 105, is the most appropriate option, or whether a more comprehensive standard should be used. Consideration should be given to the following factors:

- Users of the accounts – where there are external parties interested in the accounts, such as a bank or other funder, accounts prepared in accordance with the micro-entities regime may contain insufficient detail. In such cases, using FRS 102 section 1A, or FRS 105 with additional disclosures may be more cost-effective.
- Nature of the business and types of transactions – a company may determine that accounting under FRS 102 is more appropriate to their business model. For example, a company which has investment properties and wishes to continue to measure these at market value rather than historic cost should adopt FRS 102.
- Future plans – a company looking to expand beyond ‘micro’ size may choose to adopt FRS 102 to avoid moving to another framework at a later date.
Format of financial statements

For a micro-entity a complete set of financial statements comprises the following:

(a) a statement of financial position as at the reporting date with notes included at the foot of the statement; and

(b) an income statement for the reporting period.

As comparative figures are required, this means that as a minimum, two of each of the required financial statements and related notes. A micro-entity may use titles for the financial statements other than those used in FRS 105 as long as they are not misleading e.g. use of the term ‘balance sheet’ would be acceptable.

Statement of compliance

On the statement of financial position, FRS 105 requires the inclusion in a prominent position above the signature, a statement that the financial statements are prepared in accordance with the micro-entity provisions.

Format of Statement of Financial Position

A micro-entity shall present a statement of financial position in accordance with one of the formats set out in Section C of Part 1 of Schedule 1 to the Small Companies Regulations. Format 1 is as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Format 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Called up share capital not paid</td>
<td>X</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>X</td>
</tr>
<tr>
<td>Current assets</td>
<td>X</td>
</tr>
<tr>
<td>Prepayments and accrued income</td>
<td>X</td>
</tr>
<tr>
<td>Creditors: amounts falling due within one year</td>
<td>(X)</td>
</tr>
<tr>
<td>Net current assets/(liabilities)</td>
<td>X/(X)</td>
</tr>
<tr>
<td>Total assets less current liabilities</td>
<td>X</td>
</tr>
<tr>
<td>Creditors: amounts falling due after more than one year</td>
<td>(X)</td>
</tr>
<tr>
<td>Provisions for liabilities</td>
<td>(X)</td>
</tr>
<tr>
<td>Accruals and deferred income</td>
<td>(X)</td>
</tr>
<tr>
<td>Capital and reserves</td>
<td>X</td>
</tr>
</tbody>
</table>
Format of income statement

A micro-entity shall present its profit or loss for a period in an income statement in accordance with Section C of Part 1 of Schedule 1 to the Small Companies Regulations, as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Symbol</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>X</td>
</tr>
<tr>
<td>Other income</td>
<td>X</td>
</tr>
<tr>
<td>Cost of raw materials and consumables</td>
<td>(X)</td>
</tr>
<tr>
<td>Staff costs</td>
<td>(X)</td>
</tr>
<tr>
<td>Depreciation and other amounts written off assets</td>
<td>(X)</td>
</tr>
<tr>
<td>Other charges</td>
<td>(X)</td>
</tr>
<tr>
<td>Tax</td>
<td>(X)</td>
</tr>
<tr>
<td>Profit or loss</td>
<td>X/(X)</td>
</tr>
</tbody>
</table>

The effects of corrections of material errors and changes in accounting policies are presented as retrospective adjustments of prior periods rather than as part of profit or loss in the period in which they arise (refer to section 8 of FRS 105 ‘Accounting Policies, Estimates and Errors’).

Micro-entities do not need to prepare a directors’ report, and can take the option to file only the balance sheet (which includes the notes) at Companies House.
3. SMALL ENTITIES REGIME

Significant changes to the financial reporting landscape for small companies were made to the Companies Act in 2015. The changes arose from the implementation of the EU Accounting Directive which was intended to simplify and harmonise small company reporting across Europe, and were introduced in the UK via the Companies, Partnerships and Groups (Accounts and Reports) Regulations which came into force on 6 April 2015.

The key changes introduced include:

- setting a maximum number of disclosure notes that can be specified for small companies (although the accounts are still required to present a true and fair view);
- permitting small companies to prepare an abridged profit and loss account and balance sheet, if approved by all of the shareholders;
- removing the option to file abbreviated accounts;
- the scope of small company exemptions is widened so that small companies that are part of a group that also contains a PLC (unlisted), are no longer excluded from taking advantage of the small company exemptions; and
- increasing the small company thresholds to:
  - turnover: not more than £10.2 million
  - balance sheet: not more than £51 million
  - average number of employees: not more than 50.

These thresholds apply for accounting periods beginning on or after 1 January 2016. They can be applied early for accounting periods beginning on or after 1 January 2015 but if so then FRS 102 (or FRS 102 Section 1A) must also be applied.

The introduction of FRS 102 and the micro-entities regime, coupled with the changes above, necessitated a new accounting framework for small entities. After extensive consultation, the FRC determined that small entities should apply FRS 102 for recognition and measurement, with separate presentation and disclosure requirements. They can of course choose to apply FRS 102 in full.

FRS 102 – Section 1A

This new section of FRS 102 sets out the information that requires to be presented and disclosed in the financial statements of a small entity that chooses to apply the small entities regime. Unless specifically excluded by the content of section 1A, all of the requirements of FRS 102 apply to a small entity, including the recognition and measurement requirements. Unless a small entity chooses to apply EU-adopted IFRS, or if eligible, FRS 101, a small entity that chooses not to apply the small entities regime is required to apply FRS 102 excluding Section 1A.

Section 1A applies to all small entities applying the small entities regime, whether or not they report under the Companies Act 2006. Small entities that do not report under the Companies Act should comply with the requirements of Section 1A, and with the Small Companies Regulations (or, where applicable, the Small LLP Regulations), except to the extent that these requirements are not permitted by any statutory framework under which such entities report.
Key features of FRS 102 – Changes for small entities

- Under Section 1A of FRS 102, small entities are only required to prepare a profit and loss account and balance sheet – there is no requirement for a cash flow statement or statement of total recognised gains and losses.

- In order to comply with the EU Accounting Directive, the FRC can only specify a minimum number of disclosure notes with which small companies must comply. However, directors of small entities are still required to ensure the financial statements provide a true and fair view and therefore may need to use more judgement to determine what additional information may be needed to achieve this.

- FRS 102 will require small entities to recognise and measure more financial instruments than under the FRSSE e.g. interest rate swaps, forward foreign currency contracts.

- Small entities will be required to recognise deferred tax on the revaluation of fixed assets, including investment properties, under FRS 102.

- FRS 102 requires that gains and losses on investment properties must be recognised in profit or loss, rather than in reserves as previously required by the FRSSE. Such gains will however not constitute realised profits for the purposes of making a distribution.

- FRS 102 has been amended to require that, in exceptional circumstances, where the useful life of goodwill cannot be reliably estimated that it shall be written off over no more than 10 years. However, it is assumed that directors should be able to justify the useful life of any goodwill e.g. it may be that the useful life is deemed to be in excess of ten years.

- Section 1A of FRS 102 does not reproduce all the reporting requirements from company law applicable to small entities, unlike the FRSSE, but does include those relating to the financial statements. Small entities will need to satisfy themselves that they have met all their legal requirements.

Accounts formats

Two new options in relation to accounts formats have been brought into company law:

- the opportunity to use alternative layouts when preparing the profit and loss account and the balance sheet provided that the information given is at least equivalent to the information otherwise required by the standard formats. (This option is intended to reduce the burden of consolidation for those in a group using international accounting standards.)

- the opportunity to prepare and file ‘abridged accounts’, provided that all of the members of the company agree to the abridgement. This means that a company may prepare its profit and loss account and balance sheet with a reduced number of line items. The accounts overall, however, must give a true and fair view, therefore additional information may be required in the notes to the accounts if this approach is taken.
4. FIRST-TIME ADOPTION OF FRS 102 – THE KEY CHANGES

With all small companies moving to adopt the recognition and measurement requirements of FRS 102 for accounting periods beginning on or after 1 January 2016 at the latest, it is time to ensure that all those involved in the financial reporting process understand the key changes required by the new accounting regime. Whilst there are many similarities between FRS 102 and previous UK accounting standards, the following provides a reminder of the key areas where the accounting will change.

Transitional adjustments (Section 35 of FRS 102)

Firstly, for the first set of financial statements prepared under FRS 102, specific transition requirements are set out in section 35 of the standard. These require that financial statements are prepared in accordance with the requirements of FRS 102 as if they had always been so, subject to certain mandatory and optional exemptions, such as:

- business combinations including group reconstructions – a first-time adopter can choose not to apply section 19 of FRS 102 to business combinations effected before the date of transition;
- valuation as deemed cost – a first-time adopter can use a fair value or previous revaluation as deemed cost for an item of property, plant and equipment, investment property or intangible asset; and
- share-based payment transactions – a first-time adopter is not required to apply section 26 of FRS 102 to equity instruments that were granted before the date of transition.

The comparatives for the financial period prior to the first set of accounts prepared under FRS 102 require to be restated. The impact of this is as follows.

If we assume that a small company has a year end of 31 December, then it will be required to prepare its first set of accounts under FRS 102 for the period ending 31 December 2016. Its date of transition will be 1 January 2015, i.e. the earliest date of the financial information presented in those accounts (commencement date of comparative year). The accounts for the years to 31 December 2014 and 2015 will be prepared in accordance with the FRSSE. Users of the financial statements need to be aware that once FRS 102 is applied, the company’s opening balances as at 1 January 2015 are unlikely to be the same as the closing balances in the company’s accounts as at 31 December 2014. This is due to the likely impact of transitional adjustments and application of different accounting policies that will almost certainly be required. Likewise, the comparative reported figures for the year to 31 December 2015 are most unlikely to be the same as those previously reported for that year for the same reasons. A balance sheet is required to be prepared at 1 January 2015, but does not need to be published. Reconciliations should also be included – further information on these as well as example formats can be found in the FRC Staff Education Note 13, available from: https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/SEN-13-Transition-to-FRS-102-(amended-Oct-2015).pdf
## Illustration of Transition Dates

<table>
<thead>
<tr>
<th>Year end</th>
<th>Transition date</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 2016</td>
<td>1 January 2015</td>
</tr>
<tr>
<td>31 March 2017</td>
<td>1 April 2015</td>
</tr>
<tr>
<td>30 April 2017</td>
<td>1 May 2015</td>
</tr>
<tr>
<td>30 June 2017</td>
<td>1 July 2015</td>
</tr>
<tr>
<td>30 September 2017</td>
<td>1 October 2015</td>
</tr>
</tbody>
</table>

### Investment properties

Under FRS 102, gains or losses on the revaluation of an investment property will be required to be included in the profit or loss for the year. This is in contrast to the previous treatment for such gains or losses being posted via the Statement of Recognised Gains and Losses to the Revaluation Reserve. This change will therefore have an impact on the reported bottom line in the profit and loss account without any change in the economic substance of the entity’s activities. Such changes will end up in the profit and loss account reserve although entities may decide to transfer such amounts to a separate reserve, as these profits or losses will not be realised and hence do not impact on the level of profits that may be distributed. Additionally, old UK GAAP prohibits a company from classifying an asset as an investment property, if that property is occupied by another company in the group. This prohibition is removed under FRS 102 and such properties will now be accounted for as investment properties in the individual company accounts. Please note that under its triennial review of FRS 102, the FRC is proposing to permit an accounting policy choice for entities that rent investment property to another group entity, whereby they can choose to measure the investment property either at cost (less depreciation and impairment) or at fair value. It is expected that this change will take effect for accounting periods beginning on or after 1 January 2019.

Companies normally had to invoke the Companies Act 2006 true and fair override to enable them to recognise investment properties at market value (and therefore not to charge depreciation) in accordance with the requirements of Statement of Standard Accounting Practice (SSAP 19)/FRSSE. This approach will no longer be required as under FRS 102, investment properties are now measured in accordance with the fair value accounting rules of the Companies Act. Although FRS 102 requires investment properties to be measured at fair value, in contrast to SSAP 19 which required them to be measured at “open market value”, we do not see this as having any impact on valuations in practice. Deferred tax must be provided on all fair value gains and losses.

### Goodwill and intangible assets

For companies acquiring another entity post implementation of FRS 102, greater consideration needs to be given to the actual assets acquired as at the date of acquisition. UK GAAP previously required the intangible assets to be recognised only where they are capable of being sold separately from the entity as a whole. This requirement has limited the nature and number of intangible assets recognised in practice. FRS 102 widens the definition of intangible assets and permits intangible assets acquired in a business combination to be recognised separately from goodwill if the fair value can be measured reliably, which could result in the recognition of more intangible assets on acquisition, the net result of which will be to reduce the level of goodwill recorded on the balance sheet. As part of the triennial
review, the FRC is proposing that in order to address implementation issues, entities will be required to recognise fewer intangible assets acquired in a business combination separately from goodwill. This will reduce the costs of compliance, whilst still providing users with useful information about the business combination. It is expected that this change will take effect for accounting periods beginning on or after 1 January 2019.

**Deferred taxation**

The method of determining deferred tax under FRS 102 has been changed to a “timing differences plus” approach. This is likely to have a significant impact in practice as more companies are going to be required to include provisions in respect of deferred tax. Currently, companies which revalue fixed assets, including investment properties do not recognise the related deferred tax aspects of that revaluation but merely provide information of such in the notes to the accounts. However, FRS 102 requires the deferred tax on such gains or losses to be provided for in the primary financial statements and discounting of any such balance is not permitted.

**Defined benefit pension schemes**

Disclosure of the pension scheme deficit no longer requires to be included separately on the balance sheet and hence, going forward, may well be included in other liabilities with details of the deficit reported in the specific note to the accounts.

Any related deferred tax will now be reflected in the deferred tax balance and not offset against the gross surplus or deficit of the scheme.

**Group defined benefit plans**

Going forward individual members of a group defined benefit pension scheme will be required to include their respective share of the assets and liabilities of the group scheme. If there is no contractual agreement in place between the respective group companies then the company which has legal responsibility for the scheme, in most cases the parent company, will have to reflect all of the assets and liabilities on its individual company balance sheet. Previously, only the group accounts had reflected the pension scheme position.

**Multi-employer schemes**

In situations where there is a multi-employer defined benefit pension scheme then these can continue to be accounted for as defined contribution pension schemes i.e. the only charge to the profit and loss account in the year will be the contributions payable figure (provided that it is not possible to separately identify the individual entity’s share of the scheme assets and liabilities). Such schemes are common in the charity and university sectors. However, if such a scheme has agreed a deficit recovery plan then this deficit will require to be recognised. This recognition could have a significant impact on the balance sheet reported and in some cases might even result in the balance sheet reporting a negative position.

**Holiday pay**

Whilst a strong argument can be made for accruing holiday pay under existing UK GAAP, in practice this has rarely been done. FRS 102, however, specifically requires that holiday pay is accrued where applicable. This is most likely to be an issue in companies in which the holiday year does not match the accounting year. In cases where the holiday year mirrors that of the accounting year then this will not be an issue if employees are not allowed to carry forward any unused holidays.
5. FINANCIAL INSTRUMENTS

For many organisations transitioning to new GAAP, one of the key areas that could change is the treatment of financial instruments. In this section we set out some of the main accounting changes for financial instruments.

For the very many UK companies and other bodies which did not previously apply FRS 26 “Financial Instruments: Recognition and Measurement” and the fair value accounting rules under the Companies Act, the area of financial instruments will not have figured much in the preparation of their financial statements, and they may therefore think that it will not affect them in the future. But the definition of financial instruments is fairly wide-ranging, so everyone applying FRS 102 (including FRS 102 section 1A) will need to consider what financial instruments they have (both on and off balance sheet) and determine how they will be accounted for.

Definition of financial instrument

FRS 102 defines a financial instrument as ‘a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.’ The standard contains two sections – basic financial instruments (section 11) and other financial instrument issues (section 12). It is expected that section 11 will apply to all entities, while section 12 will also apply where more complex financial instruments are held. Additionally, certain items that satisfy the definition of a financial instrument such as a lease are specifically scoped out of these sections because they are covered by a separate stand-alone section in the standard.

Basic financial instruments

Section 11 states that financial instruments that usually meet the definition of ‘basic’ include:

(a) cash;
(b) demand and fixed-term deposits when the entity is the depositor, e.g. bank accounts;
(c) commercial paper and commercial bills held;
(d) accounts, notes and loans receivable and payable;
(e) bonds and similar debt instruments;
(f) investments in non-convertible preference shares and non-puttable ordinary and preference shares; and
(g) commitments to receive a loan and commitments to make a loan to another entity.

In the following section, we set out some common ‘basic’ financial instruments that a company might hold, and look at how the accounting will change under FRS 102.

Bank loan

The guidelines on which loans and other debt instruments can be treated as ‘basic’ and accounted for at amortised cost, are very specific and rules-based, therefore companies will need to make a very careful analysis of the terms and conditions of any loans they have to ensure they are classified appropriately.
Debt instruments that fall to be treated as ‘basic’ are measured initially at the transaction price (including transaction costs) and then at amortised cost using the effective interest rate method. The amortised cost is calculated as the net of the following:

(a) the amount at which the financial asset or financial liability is measured at initial recognition;
(b) minus any repayments of the principal;
(c) plus or minus the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition and the maturity amount;
(d) minus, in the case of a financial asset, any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

The example below illustrates how amortised cost is calculated on a five year loan:

On 1 January 20X0, an entity receives a loan of £1,000,000, incurring administration costs of £50,000. Interest of £40,000 is payable annually, in arrears, over the next five years (31 December 20X0 to 31 December 20X4). The total amount repayable at 31 December 20X4 is £1,100,000.

<table>
<thead>
<tr>
<th>Year</th>
<th>Carrying amount at beginning of period</th>
<th>Interest income at 6.9583%*</th>
<th>Cash outflow</th>
<th>Carrying amount at end of period</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0</td>
<td>£950,000</td>
<td>£66,110</td>
<td>(40,000)</td>
<td>£976,110</td>
</tr>
<tr>
<td>20X1</td>
<td>£976,110</td>
<td>£67,920</td>
<td>(40,000)</td>
<td>£1,004,030</td>
</tr>
<tr>
<td>20X2</td>
<td>£1,004,030</td>
<td>£69,860</td>
<td>(40,000)</td>
<td>£1,033,890</td>
</tr>
<tr>
<td>20X3</td>
<td>£1,033,890</td>
<td>£71,940</td>
<td>(40,000)</td>
<td>£1,065,830</td>
</tr>
<tr>
<td>20X4</td>
<td>£1,065,830</td>
<td>£74,160</td>
<td>(40,000)</td>
<td>£1,100,000</td>
</tr>
</tbody>
</table>

* The effective interest rate of 6.9583 per cent is the rate that discounts the expected cash flows on the bond to the initial carrying amount:

$$\frac{40}{(1.069583)^1} + \frac{40}{(1.069583)^2} + \frac{40}{(1.069583)^3} + \frac{40}{(1.069583)^4} + \frac{940}{(1.069583)^5} = 850$$

Related party loans

One common group of financial instruments which could be treated significantly differently under FRS 102 is loans to or from directors or group companies, which may not be at a market rate of interest.

Directors’ loans that are repayable on demand

On occasion there are formal written agreements in place but, more often than not, such loans are made on an informal basis. Where there is no documentation of the agreed terms it is probably the case that such loans will require to be treated as basic debt financial instruments which are repayable on demand and accounted for accordingly. For a loan from a company to a director that is repayable on demand this will be shown as a current asset and for a loan from a director to a company that is repayable on demand this will be shown as a current liability. One would normally expect such loans to be recognised and subsequently measured at the transaction amount (including transaction costs) i.e. the amount that was loaned by either party.
Fixed term loans

Without appropriate documentation it will harder to prove that a loan is not repayable on demand. Therefore, consideration should be given to formally documenting loans where the intention is that the loan is not repayable on demand. If the conditions of a loan are documented, then it is an easy task to determine whether it is repayable on demand or rather is a fixed term loan. Fixed term loans are most probably basic debt financial instruments. Of course every such loan would need to be considered on its own merits and the conditions applicable in paragraph 11.9 of FRS 102 considered.

Another common feature of directors’ loans is that even although there may be a written contract many do not mention a rate of interest and are therefore deemed to be interest free. Furthermore, at least some such loans where the interest rate is stated will be at an interest rate which is less than the prevailing market rate. Such transactions need to be accounted for as financing transactions where they are not repayable on demand and where the interest rate is not set at the market rate. (If repayable on demand, then the present value of a financial asset or financial liability that is repayable on demand is equal to the undiscounted cash amount payable reflecting the lender’s right to demand immediate repayment.) Where a loan is deemed to be a financing transaction the initial loan recognised will be less than the amount loaned. In terms of the accounting entries this therefore means that there will be a debit or credit measurement difference. FRS 102 is silent on how such differences should be treated. As per the Financial Reporting Council’s (FRC) Staff Education Note 16 ‘Financing Transactions’ if the loan is from the director to the company then the difference will be a credit and in many cases will be treated as a capital contribution. If the loan is from the company to the director, then the debit difference will generally be treated as a distribution to the owner. The accounting treatment will of course depend on whether the loan was made in the director’s capacity as a shareholder or for another reason.

Example of initial measurement:

A parent company grants an interest-free loan of £100,000 to its subsidiary on 1 January 20X0. The loan is repayable on 31 December 20X0. The market rate for a similar loan is 10%, therefore the loan is initially measured at 100,000/1.1 = £90,900. The balancing figure of £9,100 would be treated as a capital contribution, and recognised directly in equity by the subsidiary.

A distribution recorded in the financial statements in accordance with FRS 102 may not however be a distribution as a matter of law. The legal requirements on distributable profits are addressed in the ICAS/ICAEW Distributable Profits guidance. The presumption that the loan has been made in the director’s capacity as a shareholder can be rebutted if there is evidence to the contrary e.g. if loans between the entity and other third parties without an ownership interest in the entity (e.g. employees) are made on the same or similar terms. If an interest-free loan is made between an entity and a director who has no direct ownership interest in the entity, the terms of the loan and the reasons for making need to be assessed carefully e.g. an entity may offer interest-free loans to all employees, including its directors, as an additional employee benefit to purchase a season travel ticket. In this situation the entity accounts for the measurement difference as an employee benefit cost in accordance with Section 28 Employee Benefits of FRS 102.

Please note that under the triennial review, the FRC is proposing to simplify the accounting for small entities for a loan from a director who is a natural person and a shareholder in the small entity (or a close member of the family of that person), which will permit the loan to be initially measured at transaction price rather than present value. It is expected that this change will take effect for accounting periods beginning on or after 1 January 2019.
Investment in shares

Under old UK GAAP (excluding FRS 26), investments in shares are either measured at cost, or at a valuation under the alternative accounting rules. Under FRS 102 investments in non-convertible preference shares and non-puttable ordinary and preference shares are treated as basic, but must be measured at fair value through profit or loss, if they are traded publicly or their fair value can otherwise be measured reliably. An entity should use the following hierarchy to estimate the fair value of the shares (FRS 102 11.27):

(a) The best evidence of fair value is a quoted price for an identical asset in an active market. Quoted in an active market in this context means quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm’s length basis. The quoted price is usually the current bid price.

(b) When quoted prices are unavailable, the price of a recent transaction for an identical asset provides evidence of fair value as long as there has not been a significant change in economic circumstances or a significant lapse of time since the transaction took place. If the entity can demonstrate that the last transaction price is not a good estimate of fair value (e.g. because it reflects the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted.

(c) If the market for the asset is not active and recent transactions of an identical asset on their own are not a good estimate of fair value, an entity estimates the fair value by using a valuation technique. The objective of using a valuation technique is to estimate what the transaction price would have been on the measurement date in an arm’s length exchange motivated by normal business considerations.

As the changes in fair value are recognised in profit or loss, rather than via reserves, this could introduce greater volatility into a company’s reported results. Companies will need to ensure that they are able to access valuations for their investments at the initial transition date to FRS 102 in order to prepare their opening balance sheet, and as necessary on an ongoing basis in future years.

On occasion if the shares in question are not listed and their respective fair value cannot be determined reliably then they should be reflected at their transaction price which includes any directly related purchase costs e.g. commission costs.

‘Other’ financial instruments

Section 11 of FRS 102 is intended to encompass all of the most common types of financial instruments that a straightforward business will deal with. However, it does not necessarily follow that these types of entity will never have to look at section 12 – ‘other financial instruments.’ Some fairly commonplace financial instruments will not be within the scope of section 11, such as common derivatives like interest rate swaps and foreign currency forward contracts.

As with investments in shares included as ‘basic’ financial instruments above, companies will need to ensure that they identify all derivatives and other financial instruments and ensure that they obtain valuations for these at the transition date.
6. NEW FILING REQUIREMENTS FOR SMALL ENTITIES

One of the key changes for small companies under the new Companies Act requirements is the abolition of abbreviated accounts. Small companies will now need to consider more carefully exactly what information they must file with Companies House.

The new requirements introduce the principle of ‘file what you prepare’ so that small companies may:

- Prepare and file full accounts.
- Prepare and file ‘abridged accounts’ (all members must agree to the abridgement).
- Use the option (under section 444(1) – this option was first introduced in the CA 2006) – not to file the profit and loss account and directors report i.e. file only the balance sheet and related notes.

It is likely that many companies will choose the third option which is most similar to abbreviated accounts i.e. it minimises the amount of information on the public record.

**What should be filed for a small company under section 444 of the Companies Act**

The ‘file what you prepare’ approach means that a small company must file at Companies House ‘the’ balance sheet it prepares for members, rather than ‘a’ balance sheet under the previous legislation (which allowed for the use of the abbreviated format).

The starting point for filing is therefore the full accounts – minus the directors’ report and profit and loss account (including any directly related notes). Section 472 of the Companies Act defines notes as follows:

References in this Part to a company’s annual accounts, or to a balance sheet or profit and loss account, include notes to the accounts giving information which is required by any provision of this Act or international accounting standards, and required or allowed by any such provision to be given in a note to company accounts.

Therefore, it can be interpreted that notes can be classified as:

- Notes to the accounts (e.g. accounting policies).
- Notes to the balance sheet (i.e. notes that relate to specific line items in the balance sheet).
- Notes to the income statement (i.e. notes that relate to specific line items in the income statement).

All of the notes required to be presented by small companies adopting the small companies regime are set out in Appendix C to section 1A of FRS 102. Beyond this, small companies are required to present any additional notes necessary to give a true and fair view.

Working on the basis of the three categories of notes set out above, the only note specified in FRS 102 section 1A relating to the profit and loss account/income statement is:

- ‘The amount and size of any individual items of income or expense of exceptional size or incidence must be stated.’ (1A.32)
FRS 102 also lists as a ‘note supporting the income statement’ - ‘the average number of persons employed by the small entity in the reporting period.’ However, this fits more readily into the category of a ‘note to the accounts’ since it does not relate to a specific income statement line item, therefore should be filed with the balance sheet.

The only notes that may be omitted from the filed accounts are therefore any directly related to a profit and loss account line item that a company has chosen to present in order to provide a true and fair view. The end result is that it is likely that small companies taking this filing option will file a greater number of notes than they did under abbreviated accounts (e.g. related parties will be required). There will also be a greater variation in the notes filed by different companies, dependent on factors such as the nature of their activities, and whether or not they have prepared an abridged balance sheet.

Audit report

Under the previous requirements, if a small company takes the option not to file its P&L account and directors’ report but the accounts are audited, it is required to file the full audit report.

The 2015 regulations remove this requirement – instead if the accounts are audited, the filed balance sheet must include a note which must:

- state whether the auditor’s report was qualified or unqualified;
- if the report was qualified, disclose the basis of the qualification and reproduce any statement under section 498(2)(a), if applicable;
- if the report was unqualified, but contained an emphasis of matter paragraph (for example because of going concern issues), this emphasis of matter paragraph should be included; and
- provide the name of the auditor and (where the auditor is a firm) the name of the person who signed the auditor’s report as senior statutory auditor.
7. EARLY ADOPTION

Early adoption of the new company law requirements and FRS 102 section 1A may be an attractive option for some companies, but it is important to understand which provisions can be adopted early and when.

What changes can be adopted early

The changes to the Companies Act 2006 that were introduced by The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 should be viewed as a package that must be adopted for accounting periods beginning on or after 1 January 2016, but may also be adopted for accounting periods beginning on or after 1 January 2015, provided that FRS 102/FRS 102 (section 1A) is also adopted.

This means that a company that is currently medium-sized, but will be treated as small under the new size criteria (i.e. turnover £10.2 million, balance sheet £5.1 million) can early adopt the new regulations and FRS 102 section 1A, therefore avoiding moving to full FRS 102 for one year, and then moving to FRS 102 section 1A in the next year.

The FRSSE is incompatible with the requirements of the regulations, therefore an entity using the FRSSE for its 2015 accounts cannot early adopt the changes such as the increased thresholds.

<table>
<thead>
<tr>
<th>Accounting periods</th>
<th>Companies already qualifying as small and applying the FRSSE</th>
<th>Companies that do not qualify as small but would do so under the increased thresholds</th>
</tr>
</thead>
<tbody>
<tr>
<td>beginning on or after 1 January 2015 but before 1 January 2016</td>
<td>May apply FRSSE (2015) and file abbreviated accounts or may early adopt FRS 102 including section 1A small entities (or full FRS 102), and the 2015 accounts regulations (abbreviated accounts may not be filed).</td>
<td>Must apply FRS 102, and may early adopt section 1A small entities and the 2015 accounts regulations.</td>
</tr>
<tr>
<td>beginning on or after 1 January 2016</td>
<td>Must apply FRS 102 with or without section 1A and 2015 accounts regulations.</td>
<td>Must apply FRS 102 with or without section 1A and 2015 accounts regulations.</td>
</tr>
</tbody>
</table>

The table includes the options most likely to be taken up by small companies. There are alternatives e.g. where applicable small companies could adopt FRS 101 or FRS 102 with the reduced disclosure framework for qualifying entities.

Micro-entities

The new standard for micro-entities, FRS 105, applies for accounting periods beginning on or after 1 January 2016, with early adoption available from 1 January 2015. Alternatively, micro-entities can continue to apply the FRSSE (with micro-entity amendments), but only for accounting periods commencing before 1 January 2016.
Audit threshold

The audit threshold also increases for accounting periods beginning on or after 1 January 2016, to retain the alignment with the small company definition. The increased audit threshold is not available for early adoption. This means that for accounting periods commencing on or after 1 January 2015 but before 1 January 2016, a company can apply the new limits for financial reporting purposes, but will still need to use the old limits for assessing whether an audit is required.
8. TAX IMPLICATIONS OF NEW UK GAAP

This section looks at the key tax implications of the transition to FRS 102. Changes in accounting treatment on implementation of the new UK GAAP can have a significant impact on UK tax liabilities.

**Accounting transition to FRS 102**

To recap, entities applying FRS 102 for the first time must restate their balance sheet for the beginning and end of the comparative period. For example, where the first period of account of mandatory application is the year ending 31 December 2015, they must restate their opening balance sheet as at 1 January 2014 (known as the date of transition) and their comparative balance sheet as at 31 December 2014.

Transition to FRS 102 impacts on an entity’s accounts in two key ways:

- assets and liabilities at the date of transition are identified, recognised and measured in line with the requirements of FRS 102 (subject to some mandatory and some optional exemptions); and
- thereafter profits and losses are recognised in accordance with FRS 102, and are likely to differ from those that would have been reported had the old UK GAAP been retained.

On transition there may be a significant number of adjustments – both to the carrying value of assets and liabilities recognised previously under the old UK GAAP, and in terms of assets and liabilities newly recognised under FRS 102. For accounting purposes these adjustments are made as at the date of transition, with corresponding adjustments directly to the opening reserves.

**Tax implications of the transition**

HMRC require financial statements for tax purposes to be prepared in accordance with GAAP.

A change of accounting basis from one valid basis to another, or a change of accounting policy such as a change from the old UK GAAP to FRS 102, may bring about prior period adjustments. Positive adjustments, which increase profits or reduce losses, are taxed as receipts. Negative adjustments are allowed as expenses. For tax purposes these prior period adjustments are treated as arising on the date of transition.

In December 2016, HMRC updated their FRS 102 overview paper containing guidance on the corporation tax implications of applying FRS 102. They have also published a new overview paper covering the income tax implications, which will be helpful to unincorporated entities. These provide a comparison of the accounting and tax differences between the old UK GAAP and FRS 102, and a summary of the key accounting and tax considerations that arise for entities transitioning from the old UK GAAP to FRS 102. It is equally relevant to smaller entities electing to apply section 1A of FRS 102.

The guidance from HMRC tabulates certain transition adjustments that may be required for accounting purposes, and their tax implications, including:

- accounting adjustments recognised as at the date of transition – to ensure that business receipts are taxed only once and deductions are given only once;
• accounting adjustments reflecting changes of accounting policy;
• differences in the treatment of intangibles; and
• adjustments in the treatment of loan relationships or derivative contracts.

The following are examples of ways in which differences between FRS 102 and the old UK GAAP may affect both the current tax computation and the calculation of deferred tax liabilities:

• Investment property: Under FRS 102, gains and losses on fair value fluctuations are taken directly to profit or loss (although are not distributable profits); this contrasts with their being recognised previously as unrealised gains in the Statement of Total Recognised Gains and Losses.
• Intangible assets and goodwill: Under FRS 102, where the entity is unable to estimate reliably the useful economic life, it should not exceed 10 years.
• Financial instruments: The FRS 102 treatment for many basic financial instruments is the amortised cost basis of accounting.
• Loan relationships: FRS 102 requires loans not at a market rate of interest to be discounted, unless they are repayable on demand.
• Leasing: FRS 102 regards a lease as indicative of a finance lease when ‘substantially all’ of the present value of the minimum lease payments is equivalent to the fair value of the leased asset; there is no 90% test, but this is not anticipated to result in a major change in practice.
• Stock valuation: FRS 102 prohibits the use of the LIFO method.
• Grants: FRS 102 offers a choice of accounting policies – a performance model and an accrual model – the latter being similar in nature to previous accounting requirements.
• Employee benefits: FRS 102 requires accruals to be made for unpaid short-term employee benefits such as unpaid sick pay and holiday entitlement.
• Deferred tax: Under FRS 102, deferred tax is recognised on a revalued asset, regardless of whether or not there is a binding agreement to sell, and the tax rate is that which would apply on a disposal.

Health warning

Feedback from HMRC suggests that some entities are failing to apply FRS 102 correctly, or not recognising appropriate tax adjustments on the transition. Where this causes incorrect self-assessment of tax liabilities, any under-declaration of tax may attract interest and penalties.

HMRC’s overview paper provides only general guidance and is not intended as a substitute for detailed study of FRS 102 and the related tax law. Changing the basis on which accounts are prepared is a complex matter. Practitioners need to be able to ensure that their clients comply with the new UK GAAP, and that the tax implications of transition adjustments are duly recognised.
9. FURTHER INFORMATION

**Accounting standards**

The suite of new UK GAAP accounting standards is available to download from the FRC website at:


The FRC has published a number of Staff Education Notes on specific aspects of the application of FRS 102:


**Company law**

Please note that the official version of the Companies Act 2006 available on www.legislation.gov.uk has not yet been updated to reflect the changes made by SI 2015/980.

**ICAS.com**

ICAS.com has a number of articles and details of courses on new UK GAAP. Please search under the ‘corporate & financial reporting’ tab.

**Tax**

HMRC has published three overview papers on the tax implications of FRS 101 and 102, available from the following links:


**SORPs**

Details of SORPs that apply to specific industries are available from the FRC website:


**Distributable profits**

The ICAEW/ICAS guidance on distributable profits has been updated to reflect the introduction of FRS 102 and is available from the ICAS website (currently in draft form):
