FRS 102; The Transitional Arrangements

In this edition of Accountancy Plus Robert Kirk examines the need for accountants to prepare well in advance in order to ensure a smooth transition to the new standard.

Introduction

Many accountants are still not aware of how close we are to the implementation of FRS 102 to Irish published accounts. The standard must be fully implemented for all accounting periods ending on or after the 31st December 2015 but there is also a requirement to ensure that the comparatives figures are also based on FRS 102. In effect, that means that it has to apply to the year ended 31st December 2014 as well. The standard sets out very clearly in Section 35 how the transitional arrangements will work during that comparative year. It is important, therefore, that all accountants who are involved in the financial reporting of non-listed companies become very familiar with that Section of the standard fairly quickly.

Date of Transition

A large percentage of Irish company financial years' end on the 31st December and these are the companies that must implement FRS 102 first. Other later year ends in March, June and September will follow thereafter. When a company switches over to FRS 102 with a December year end it must identify its date of transition and that is the first day of the previous comparative year end to full implementation i.e. 1st January 2014. That date is only three months away!! This article will concentrate on a company with a 31st December year end but obviously the same process will occur, only later, for other year ends.

What disclosure must be provided?

All entities will have to explain how the transition from adopting FRSs/SSAPs to the new FRS has affected the financial position and performance of the reporting entity. In order to achieve that, the first financial statements (i.e. 31st December 2015) must include:

- a description of the nature of each change made to accounting policies
- a reconciliation of equity reported under FRSs/SSAPs to equity under the FRS for both:
    - the date of transition (i.e. 1st January 2014); and
    - the end of the latest period presented in the entity's most recent annual financial statements under previous SSAPs/FRSs (i.e. 31st December 2014); and
- a reconciliation of profit or loss reported under previous SSAPs/FRSs for the latest period to the profit or loss under the new FRS for the same period i.e. for the year ended 31st December 2014).

If an entity becomes aware of errors made under previous standards the reconciliations must distinguish those errors from any changes made in accounting policy.

However, if a reporting entity did not previously present financial statements it instead must disclose that fact in its first FRS 102 financial statements.

What is the process that a company must adopt in the transitional phase?

All reporting entities must, in their opening balance sheet at the date of transition carry out the following procedures:

- recognise all assets and liabilities required by the FRS (now opportunity to capitalise development costs, to include additional intangible assets on an acquisition made in 2014 such as customer lists or non-contractual customer relationships).
- not recognise assets or liabilities if the FRS does not permit such recognition (unlikely to be any but if a company had capitalised homegrown intangibles that is unacceptable under the new FRS.)
- reclassify items recognised previously as one type of asset, liability, equity etc but are recognised as different types under the FRS (now deferred tax assets must be reclassified as non-current assets); and
- apply the FRS in measuring all recognised assets and liabilities (possible opportunity to go back to cost from fair valuing property, need to recognise gains and losses on investment property through profits and NOT through reserves).

The accounting policies adopted in the opening balance sheet may differ from previous SSAPs and FRSs and therefore any adjustments must be recognised directly in retained earnings at the date of transition to the FRS.

Are there any exemptions from having to carry out the above procedures?

On first time adoption of the FRS, the following must NOT be changed on transition and must continue to be accounted for under previous FRSs or SSAPs:

- derecognition of financial assets and liabilities
  (not allowed to bring back financial assets or liabilities if previously derecognised under Irish Gaap nor to bring in new financial assets/liabilities even if could be recognised under the new FRS)
- hedge accounting
  (not allowed to change hedge accounting before the date of transition for hedging relationships that no longer exist at the date of transition. For those that did exist at the date of transition, must follow the hedge accounting requirements of Section 12 including the requirements for discontinuing hedge accounting)
- accounting estimates;
- discontinued operations;
- measuring non-controlling interests
  (only split profit and other comprehensive income prospectively and must not change previous accounting for loss of control nor changes in a parent's interest not involving a change in control)

In addition, there are a number of other possible exemptions which entities may adopt:

Business combinations
Companies may elect not to adopt Section 19 for past combinations but if they do restate any previous combination they must also restate all later combinations i.e. if treated as a merger previously there is no need to adjust to acquisition accounting for past business combinations.

Share based payment transactions
Companies are encouraged but not required to apply Section 26 to equity granted schemes before the date of transition or to liabilities settled before the date of transition.

Fair value as deemed cost
Companies may adopt the previous revaluation under the FRSs/SSAPs as their deemed cost of an asset under the FRS.

Compound financial instruments
There is no need to separate its two components into debt/equity if the debt component is not outstanding at the date of transition.

Service concession arrangements (i.e. PPP/PFI)
Not required to apply Section 34 to service concession arrangements entered into before the date of transition to the FRS.

Extractive activities
If a company has adopted full cost accounting under FRSs/SSAPs it may elect to measure oil and gas assets on the date of transition at the amount determined under the FRSs/SSAPs. However, those assets must be tested for impairment at the date of transition to the FRS in accordance with Section 27.

Arrangements containing a lease.
A company may elect to determine whether an arrangement existing at the date of transition contains a lease on the basis of facts and circumstances existing at that date, rather than when the arrangement was entered into.

Decommissioning liabilities included in the cost of property, plant and equipment.
Section 17 states that the cost of an item of property etc includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. Entities may elect to measure this component of the cost of an item of property at the date of transition, rather than on the date(s) when the obligation initially arose.

Dormant companies
These companies may elect to retain their existing accounting policies for the measurement of reported assets, liabilities and equity at the date of transition to this FRS until there is any change to those balances or the company undertakes any new transactions.

Deferred development costs
A first-time adopter may elect to measure the carrying amount at the date of transition to this FRS for development costs deferred in accordance with SSAP 13 *Research and development* as its deemed cost at that date.

Borrowing costs
An entity electing to adopt an accounting policy of capitalising borrowing costs as part of the cost of a qualifying asset may elect to treat the date of transition to this FRS as the date on which capitalisation commences.

Public benefit entity combinations
A first time adopter may elect not to apply Section 34 relating to PBE combinations that were effected before the date of transition to this FRS. However, if on first-time adoption a PBE restates any entity combination to comply with this section, it must restate all later entity combinations.

What happens if I cannot restate the comparatives?

If a company finds it impracticable to restate the opening balance sheet at the date of transition for one or more of the adjustments it must apply those adjustments to the earliest period for which it is practicable to do so, and also identify the data presented for prior periods that are not comparable with the data for the period in which it prepares its first financial statements that conform to this FRS.

If it is impracticable to provide any disclosures required by FRS 102 for any period before the period in which it prepares its first financial statements that conform to this FRS, the omission must be disclosed.

Practical example of date of transition reconciliations

Example

Portmuck Ltd started its operations on 1 January 2010 and elected a reporting date of 31 December. The entity has been preparing its financial statements in accordance under Irish Gaap since January 2010.

In 2015 the entity's management decided to adopt FRS 102. The financial statements for the year ended 31 December 2015 are the first set of financial statements presented by Portmuck Ltd that comply with FRS 102, including an explicit and unreserved statement of compliance with the FRS. Those financial statements include only one year of comparative information (i.e. the year 2014). The entity's date of transition to FRS 102 is 1 January 2014.

Portmuck Ltd adopted some accounting policies that differ from the accounting policies required or allowed by the FRS 102. The following is the list of the effects of those material differences:

(a) Depreciation of the entity's head office in accordance with the previous financial reporting framework was calculated without reference to its revised residual value, and as a consequence, at 1 January 2014 the carrying amount of fixed assets was €15,000 lower than what it would have been if the entity had applied FRS 102. Profit for 2014 was €1,800 lower than if FRS 102 was used.

(b) Included in tangible assets is a school building which was designed, built and operated by the company on behalf of the local Education Board costing €780,000 under a PPP scheme. The effect on profit is not material.

(c) Intangible assets, in accordance with Irish Gaap at 1 January 2014, failed to include €5,000 for purchased customer lists that in accordance with the FRS 102 should have been recognised separately because they qualify for recognition as separate intangible assets. The effect on profit for 2014 is not material.

(d) Financial assets that Section 12 *Other Financial Instruments Issues* require to be accounted for at fair value through profit or loss were, in accordance with Irish Gaap, carried at cost. As a consequence, at 1 January 2014 the carrying amount is €1,100 lower than if the FRS 102 had been used. In 2014 the increase in fair value of such financial assets was €1,600.

(e) A hedge relationship that qualifies for hedge accounting under paragraph 12.16 that hedges the foreign exchange risk of a particular forecast sale (i.e. forward foreign exchange contract) exists at the date of transition. In accordance with the previous financial reporting framework, the hedging instrument was carried at cost (nil). Consequently, the €1,200 of unrealised foreign exchange gains on the unmatured hedging instrument was not recorded in equity. In 2014 the decrease in fair value of such financial assets was €600.

(f) In accordance with Irish Gaap, the cash basis was used to account for a particular pension liability as it was treated as defined contribution scheme. Consequently, at 1 January 2014, it was redefined as a defined benefit scheme and an employee benefits liability of €1,900 needs to be created on the entity's balance sheet and profit for the year 2014 should be €1,100 lower (i.e. cost of sales higher by €600, distribution costs higher by €300 and administrative expenses higher by €200) under FRS 102.

(g) At 1 January 2014, a restructuring provision of €6,200 relating to head office activities was recognised under FRS 12 *Provisions, contingent liabilities and contingent assets*, but does not qualify for recognition as a liability in accordance with FRS 102. In 2014 (after the date of transition to the FRS) the €6,200 restructuring provision qualified for recognition in accordance with the FRS.

(h) Inventory which was previously been written down to net realisable value of €2,000 from cost of €3,500 is now being used profitably in the operations of the company and the writedown therefore needs to be reversed.

The following information was extracted from the balance sheet of Portmuck Ltd as at 31 December 2013 (i.e. at 1 January 2014, the date of transition):

Irish GAAP	€	€
Fixed assets		
Property, plant and equipment	91,900	
Goodwill	8,400	
Intangible assets	3,800	
Financial assets	3,800	
Total non-current assets		107,900
Current assets		
Inventories	5,800	
Trade and other receivables	4,600	
Other receivables	1,300	
Cash and cash equivalents	1,800	
Total current assets	13,500	
Creditors: amounts falling due within one year		
Trade and other payables	5,900	
Net current assets		7,600
Total assets less current liabilities		115,500
Creditors: amounts falling due after more than one year		
Interest bearing loans	17,400	
Restructuring provision	6,200	
Other liabilities	1,800	
Non current liabilities		25,400
Net assets		90,100
Issued capital		25,000
Retained earnings		65,100
Total equity		90,100

The following information was extracted from the statement of comprehensive income of Portmuck Ltd for the year ended 31 December 2014:

	Irish Gaap €
Revenue	46,200
Cost of sales	(26,700)
Gross profit	19,500
Distribution costs	(2,800)
Administrative expenses	(2,200)
Finance income	1,800
Finance costs	(3,000)
Profit for the year	13,300
Loss on translating of foreign operation	(1,800)
Total comprehensive income for the year	11,500

Solution

The following is the reconciliation of equity at 1 January 2014 (date of transition to the FRS):

Reconciliation of capital and reserves at 1 January 2014 (date of transition to FRS 102)

Note		Irish Gaap	Effect of transition to FRS 102	FRS 102
		€	€	€
	Fixed assets			
1	Property, plant and equipment	91,900	15,000	106,900
2	Goodwill	8,400	(5,000)	3,400
2	Intangible assets	3,800	5,000	8,800
3	Financial assets	3,800	1,100	4,900
	Total non-current assets	107,900	16,100	124,000
	Current assets			
4	Inventories	5,800	1,500	7,300
	Trade and other receivables	4,600	-	4,600
5	Other receivables	1,300	1,200	2,500
	Cash and cash equivalents	1,800	–	1,800
	Total current assets	13,500	2,700	16,200
	Creditors: amounts falling due within one year			
	Trade and other payables	5,900	–	5,900
	Net current assets	7,600		10,300
	Total assets less current liabilities	115,500	18,800	134,300
	Creditors: amounts falling due after more than one year			
	Interest-bearing loans	17,400	–	17,400
6	Employee benefits	–	1,900	1,900
7	Restructuring provision	6,200	(6,200)	–
	Other liabilities	1,800	–	1,800
	Non current liabilities	25,400	(4,300)	21,100
	Total assets less total liabilities	90,100	23,100	113,200
	Capital and reserves			
	Issued capital	25,000	–	25,000
5	Hedging reserve	–	1,200	1,200
8	Retained earnings	65,100	21,900	87,000
	Total equity	90,100	23,100	113,200

Notes to the reconciliation of equity at 1 January 2014:

1. Depreciation in accordance with the previous financial reporting framework ignored an asset's revised residual value, but in accordance with FRS 102 an asset's depreciable amount is net of its residual value. The cumulative adjustment increased the carrying amount of property, plant and equipment by €15,000.

   Although PPP contracts are not permitted to be included as property on the balance sheet of an operator and instead a receivable should normally be reported no adjustment is required under the transitional rules of Section 35.

2. Goodwill in accordance with the previous financial reporting framework included €5,000 for items that are separable customer lists and therefore qualify for recognition as intangible assets in accordance with FRS 102 as only purchases of intangibles or intangibles acquired in a business combination are permitted on balance sheet.

3. Particular financial assets are, in accordance with FRS 102, measured at fair value with changes in fair value recognised in profit or loss. In accordance with the previous financial reporting framework those financial assets were measured at cost. As a consequence, at 1 January 2014 the carrying amount is €1,100 lower than if FRS 102 had been used. The resulting gains are included in retained earnings.

4. Inventories written down for impairment initially must be reversed if circumstances change and the inventories can be recovered above cost. €1,500 must be reversed.

5. Unrealised gains of €1,200 on unmatured forward foreign exchange contracts are recognised in accordance with FRS 102, but were not recognised in accordance with previous financial reporting framework. The resulting gains of €1,200 are included in the hedging reserve because the contracts hedge forecast sales.

6. A pension liability of €1,900 is recognised in accordance with FRS 102, but was not recognised in accordance with the previous financial reporting framework, which used a cash basis as it was thought to be a defined contribution scheme.

7. A restructuring provision of €6,200 relating to head office activities was recognised in accordance with the previous financial reporting framework, but does not qualify for recognition as a liability in accordance with FRS 102.

8. The adjustments to retained earnings are as follows:

	€
Depreciation (note 1)	15,000
Financial assets (note 3)	1,100
Inventory writedown reversal (note 4)	1,500
Pension liability (note 6)	(1,900)
Restructuring provision (note 7)	6,200
Total adjustment to retained earnings	21,900

The following is the reconciliation of total comprehensive income for 2014:

Reconciliation of total comprehensive income for 2014

Note		Irish Gaap	Effect of transition to FRS 102	FRS 102
		€	€	€
	Revenue	46,200	–	46,200
1, 2	Cost of sales	(26,700)	(2,100) (a)	(28,800)
	Gross profit	19,500	(2,100)	17,400
5	Other income	–	1,600	1,600
1, 3	Distribution costs	(2,800)	1,500 (b)	(1,300)
1, 4	Administrative expenses	(2,200)	(6,400) (c)	(8,600)
	Finance income	1,800	–	1,800
	Finance costs	(3,000)	–	(3,000)
	Profit for the year	13,300	(5,400)	7,900
	Cash flow hedges	–	(600)	(600)
	Loss of translating of foreign operation	(1,800)	–	(1,800)
	Other comprehensive income	(1,800)	(600)	(2,400)
	Total comprehensive income	11,500	(6,000)	5,500

Notes to the reconciliation of total comprehensive income for 2014:

1 A pension liability is recognised in accordance with FRS 102, but was not recognised in accordance with the previous financial reporting framework. The pension liability increased by €1,100 during 2014, which caused increases in cost of sales (€600), distribution costs (€300) and administrative expenses (€200).

2 Cost of sales is higher by €1,500 in accordance with FRS 102 because inventories include a reversal of inventory writedown.

3 Depreciation of property, plant and equipment decreased by €1,800 during 2014 because, unlike the previous financial reporting framework, depreciation of buildings in accordance with the FRS 102 takes account of the building's revised residual value.

4 A restructuring provision of €6,200 was recognised in accordance with the previous financial reporting framework at 1 January 2014, but did not qualify for recognition in accordance with FRS 102 until the year ended 31 December 2014. This increases administrative expenses for 2014 in accordance with FRS 102.

5 Financial assets at fair value through profit or loss increased in value by €1,600 during 2014. They were carried at cost in accordance with the previous financial reporting framework. Fair value changes have been included in 'Other income'.

6 The fair value of forward foreign exchange contracts that are effective hedges of forecast transactions decreased by €600 during 2014.

(a) €2,100 = €600 pension liability increase (see note 1) + €1,500 reversal impairment (see note 2).

(b) €(1,500) = €300 pension expense increase (see note 1) less €1,800 depreciation decrease (see note 3).

(c) €6,400 = €200 pension liability increase (see note 1) + €6,200 restructuring provision (see note 4).

Summary

Practitioners and accountants in industry need to start thinking about these transitional issues now. Clearly it is important to understand the main differences between FRS 102 and current Irish GAAP. Once the differences are identified it will provide preparers with an indication as to how much work will be involved. Preparers should not wait until they MUST adopt FRS 102 to start thinking about the impact it will have on their financial statements. They should start planning NOW!

However, the FRC has tried, as far as possible, to align current standards more or less to their international counterparts and therefore still offer a number of options to preparers. For many preparers, therefore, there may only be a couple of transitional adjustments.

I have written a short booklet *FRS 102 A Quick Reference Guide* outlining the main issues in the standard which is available free of charge for members of the Institute and this should provide them with a useful starting point.