Technical factsheet

FRS 102 – small company reporting

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INTRODUCTION

FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, has been in issuance since March 2013 and became mandatory for companies not eligible to apply the small companies regime in the preparation of their financial statements for accounting periods starting on or after 1 January 2015. Small companies were moved under the scope of FRS 102 mandatorily for accounting periods starting on or after 1 January 2016. This technical factsheet has been updated to incorporate the results of the triennial review carried out by the FRC in 2017 which are expected to impact small entities. The triennial review amendments are mandatory for accounting periods commencing on or after 1 January 2019 and early adoption is permissible. We have also included a 'Frequently Asked Questions' section relating to small entities which member firms may find helpful.

FRS 102 is based on the principles found in International Financial Reporting Standards (IFRSs), specifically *IFRS for SMEs*. *IFRS for SMEs* is intended to apply to general-purpose financial statements by entities which are classed as 'small and medium-sized' or 'private' and 'non-publicly accountable'. The term 'publicly accountable' was difficult to define in the context of legislation and hence is not a recognised concept in UK GAAP.

While FRS 102 is based on the principles found in *IFRS for SMEs*, the Financial Reporting Council (FRC) has modified the requirements significantly, both in terms of the scope of entities eligible to apply the standard and the accounting treatments provided. A notable area where the FRC has substantially modified the content of *IFRS for SMEs* to arrive at FRS 102 is in relation to Section 29, *Income Tax* which is significantly different from the equivalent Section 29 in *IFRS for SMEs*. In addition, the FRC do not necessarily replicate all changes made by the International Accounting Standards Board (IASB) to IFRSs; for example, during the 2015 review of *IFRS for SMEs*, the IASB included an additional four undue cost or effort exemptions. During the triennial review, the FRC removed the undue cost or effort exemptions from FRS 102.

FRS 102 is divided into sections, and each section is organised by topic area. Cross-references to paragraphs within the standard are identified by section followed by paragraph number. Paragraph numbers are in the form of 'xx.yy', where 'xx' is the relevant section number and 'yy' is the sequential paragraph number within that section. Paragraphs which apply only to 'public benefit entities' are preceded by 'PBE'. Where FRS 102 provides examples of how certain principles are applied in the context of the standard which include monetary amounts, the measuring unit is the 'currency unit' (CU).

STANDARDS IN ISSUE AND AMENDMENTS TO THE COMPANIES ACT 2006

FRS 102 is part of a suite of standards that form 'UK GAAP'. The standards are listed below and the FRC re-issued the suite of UK GAAP in March 2018 which consolidates all changes made to the standards since their introduction, including the triennial review amendments. All references to UK GAAP in this factsheet are to the March 2018 editions:

FRS 100 *Application of Financial Reporting Requirements*

FRS 101 *Reduced Disclosure Framework*

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

FRS 103 *Insurance Contracts*

FRS 104 *Interim Financial Reporting*

FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*

Amendments affecting small companies arising from the triennial review are examined on page 8 of this factsheet.

SIZE THRESHOLDS

The thresholds which determine whether an entity is micro, small, medium-sized or large are outlined in the following table:

	Turnover	Balance sheet total	Average number of employees
Micro-entity	Not more than £632,000	Not more than £316,000	Not more than 10
Small company	Not more than £10.2m	Not more than £5.1m	Not more than 50
Small group	Not more than £10.2m net or not more than £12.2m gross	Not more than £5.1m net or not more than £6.1m gross	Not more than 50
Medium-sized company	Not more than £36m	Not more than £18m	Not more than 250
Medium-sized group	Not more than £36m net or not more than £43.2m gross	Not more than £18m net or not more than £21.6m gross	Not more than 250
Large company	More than £36m	More than £18m	250 or more
Large group	More than £36m net or more than £43.2m gross	More than £18m net or more than £21.6m gross	250 or more

The qualifying conditions above are met by a company, or a group, in a year in which it satisfies two, or more, of the turnover, balance sheet total and employee headcount criteria. Section 382(4) of the Companies Act 2006 says that if a company has a short accounting period, the turnover figure must be proportionately adjusted.

The term **balance sheet total** is gross assets (i.e. fixed plus current assets). It is **not** net assets.

REDUCED DISCLOSURE REQUIREMENTS AND THE TRUE AND FAIR CONCEPT

Small companies and micro-entities choosing not to apply FRS 105, *The Financial Reporting Standard applicable to the Micro-entities Regime,* must use FRS 102 as a minimum. FRS 102 contains a section specifically for small entities referred to as Section 1A *Small Entities*, which was first introduced into the September 2015 edition of FRS 102. Section 1A outlines the **presentation** and **disclosure** requirements only. In terms of **recognition** and **measurement** of amounts in the financial statements, the provisions of **full** FRS 102 apply. The triennial review did, however, introduce a simplification to directors' loans in FRS 102 (March 2018), paragraph 11.13A(a) which only applies to small entities (including small LLPs). Section 1A was significantly amended as part of the FRC's triennial review to incorporate entities in the Republic of Ireland following amendments to Irish company law by virtue of the Companies (Accounting) Act 2017.

FRS 102 (March 2018), Section 1A is structured as follows:

Section	**Paragraphs**
Scope of this section	1A.1 to 1A.4
True and fair view	1A.5 to 1A.6
Statement of compliance	1A.6A
Complete set of financial statements of a small entity	1A.7 to 1A.11
Information to be presented in the statement of financial position	1A.12 to 1A.13
Information to be presented in the income statement	1A.14 to 1A.15
Information to be presented in the notes to the financial statements	1A.16 to 1A.20
Voluntary preparation of consolidated financial statements	1A.21 to 1A.22

There are five appendices attached to Section 1A in the March 2018 edition of FRS 102 as follows:

Appendix A *Guidance on adapting the balance sheet formats*

Appendix B *Guidance on adapting the profit and loss account formats*

Appendix C *Disclosure requirements for small entities in the UK*

Appendix D *Disclosure requirements for small entities in the Republic of Ireland*

Appendix E *Additional disclosures encouraged for small entities*

UK-based small entities are required to apply Appendix C and comply with the disclosures required by company law as follows:

Disclosure requirements	Paragraphs
Accounting policies	1AC.3 to 1AC.6
Changes in presentation and accounting policies and corrections of prior period errors	1AC.7 to AC.9
True and fair override	1AC.10
Notes supporting the statement of financial position	1AC.11
Fixed assets	1AC.12 to 1AC.13
Fixed assets measured at revalued amounts	1AC.14 to 1AC.18
Capitalisation of borrowing costs	1AC.19
Impairment of assets	1AC.20 to 1AC.21
Fair value measurement	1AC.22 to 1AC.25
Financial instruments measured at fair value	1AC.26
Indebtedness, guarantees and financial commitments	1AC.27 to 1AC.31
Notes supporting the income statement	1AC.32
Information about employee numbers	1AC.33
Related party disclosures	1AC.34 to 1AC.36
Other	1AC.37 to 1AC.39

The requirement to prepare financial statements which give a true and fair view is contained in section 393 of the Companies Act 2006 and there have not been any changes to this requirement. The directors of a small company still have a legal duty to ensure the entity's financial statements give a true and fair view, and they will be committing a criminal offence if they fail to comply with the true and fair requirement. It is expected that this will place an added burden on directors because merely applying the minimum legal requirements may not be sufficient in order to achieve a true and fair view, and in this respect additional disclosures beyond the requirements of the law will be needed (i.e. potentially anything in FRS 102 is disclosable if doing so enables a true and fair view to be given in the financial statements).

In light of this, the FRC has included Appendix E to Section 1A which outlines five **encouraged** disclosures which small entities should consider making, as follows:

a. a statement of compliance with FRS 102 as set out in paragraph 3.3, adapted to refer to Section 1A;
b. a statement that it is a public benefit entity as set out in paragraph PBE3.3A;
c. the disclosures relating to material uncertainties related to events or conditions that cast significant doubt upon the small entity's ability to continue as a going concern as set out in paragraph 3.9;
d. dividends declared and paid or payable during the period (for example, as set out in paragraph 6.5(b)); and
e. on first-time adoption of FRS 102, an explanation of how the transition has affected its financial position and financial performance as set out in paragraph 35.13.

Irish small entities are encouraged to provide the disclosures in b, c and e above when they are relevant to its transactions, other events and conditions.

FRS 102, paragraph 1AE.1(c) was amended as part of the triennial review to clarify that it is **material uncertainties** related to events or conditions which cast significant doubt upon the small entity's ability to continue as a going concern which need to be disclosed.

FRS 102, paragraph 1A.17 acknowledges that, while a small entity is not required to comply with the disclosure requirements of Section 3 (to the extent set out in paragraph 1A.7) and Sections 8 to 35 of FRS 102, it does refer to the disclosure requirements of those specific sections as usually being considered relevant to giving a true and fair view. As a result, paragraph 1A.17 advises small entities to consider and provide any of those disclosures which are relevant to material transactions, other events or conditions of the small entity in order to meet the requirement to prepare true and fair financial statements. Conversely, a small entity need not provide specific disclosures if the information is not material.

TRIENNIAL REVIEW AMENDMENTS RELEVANT TO SMALL COMPANIES

On 14 December 2017, the FRC issued the final amendments to FRS 102. With the exception of the amendments to FRS 105 in respect of disclosure requirements for UK-based micro-entities, all the other amendments must be applied mandatorily for accounting periods starting on or after 1 January 2019. Early adoption is permissible, provided that all the amendments are also early adopted. There are only two amendments which can be early adopted separately in respect of directors' loans to small entities and the gift aid accounting clarification (see below).

When FRS 102 was first issued in March 2013, the FRC indicated that they would review the standard every three years. This is consistent with the IASB's review of *IFRS for SMEs*. However, the Basis for Conclusions in FRS 102 (March 2018) confirms that periodic reviews of FRS 102 are likely to take place every four to five years to allow time for experience of the most recent edition of FRS 102 to develop before seeking stakeholder feedback. This is likely to be welcomed because it will allow UK GAAP time to become established prior to the review cycle commencing and should also allow the FRC to receive more constructive feedback as to potential amendments/clarifications.

That said, it is important to emphasise that should an emerging issue prove to be of an important nature, the FRC may deal with it as an ad-hoc project and amend FRS 102 (or other relevant standard) as appropriate. This approach will reduce the number of divergent practices. It is expected that the same protocol will be followed (e.g. an Exposure Draft followed by a comment period which may be three months or shorter depending on the urgency of the issue).

An important point to emphasise is that the results of the triennial review should not be viewed as making 'wholesale' changes by members. The majority of amendments made by the triennial review are editorial in nature as well as clarifying certain technical points within the standards. There are, however, some areas which will have a direct impact on small entities' financial statements which are explained below. Please note, the issues below are those which are considered particularly relevant to small entities; they do not cover all the amendments. Additional amendments to FRS 102 are contained within the Technical Factsheet: FRS 102 Reporting for Medium-sized and Large Entities. This Technical Factsheet also covers the amendments made to FRS 105.

Section 1A *Small Entities*

FRS 102, Section 1A has been amended to cater for small entities in the Republic of Ireland due to changes to Irish company law by virtue of the Companies (Accounting) Act 2017. The small companies regime for entities in the Republic of Ireland is available for periods starting on or after 1 January 2017.

The underpinning principles of Section 1A have not been changed. It still sets out the presentation and disclosure requirements which a small entity is required to follow. However, recognition and measurement of amounts in the small entity's financial statements are based on full FRS 102 (with a simplification available in respect of directors' loans to a small entity).

The disclosure requirements for small entities in the UK are set out in Appendix C *Disclosure requirements for small entities in the UK* (as was the case in the September 2015 edition of the standard). The disclosure requirements which a small entity in the Republic of Ireland is legally required to make are contained in Appendix D *Disclosure requirements for small entities in the Republic of Ireland*. The five encouraged disclosures which were contained in Appendix D in the September 2015 edition of FRS 102 have been moved into Appendix E *Additional disclosures encouraged for small entities*.

An additional paragraph has been inserted into Appendix E encouraging small entities in the Republic of Ireland to provide the disclosures in paragraphs 1AE.1(b), (c) and (e). These relate to the fact that the entity is a public benefit entity (if applicable), going concern disclosures and transitional disclosures on first-time adoption of FRS 102.

The majority of amendments to Section 1A include additional footnotes for small entities in the Republic of Ireland. A new paragraph 1A.6A has been included which requires a small entity applying Section 1A to include a statement on the balance sheet in a **prominent position above the signature** stating that the financial statements are prepared in accordance with the provisions applicable to companies subject to the small companies regime. As expected, paragraph 1AC.25 has been deleted which required disclosure of the tax treatment of items credited or debited to the fair value reserve (this was deleted as the disclosure was repealed by SI 2015/980). Other changes are merely changes to wording.

Undue cost or effort exemptions

The FRC have removed the undue cost or effort exemptions in FRS 102 on the grounds that these were not being applied correctly. The FRC became aware that the undue cost or effort exemptions were being treated as accounting policy choices, which they were not intended to be. To some extent, the confusion may have arisen because the glossary to FRS 102 does not define 'undue cost or effort', although paragraph 2.14B of *IFRS for SMEs* defines the concept as:

'Applying a requirement would involve undue cost or effort by an SME if the incremental costs (for example, valuers' fees) or additional effort (for example endeavours by employees) substantially exceed the benefits that those that are expected to use the SME's financial statements would receive from having the information.'

In some cases, the removal of an undue cost or effort exemption has been replaced by an accounting policy choice. This is particularly the case for groups which rent out property to another group member (see next). Areas of FRS 102 where undue cost or effort exemptions have been removed are:

- Section 14 *Investments in Associates* – paragraph 14.10
- Section 15 *Investments in Joint Ventures* – paragraph 15.15
- Section 16 *Investment Property* – paragraphs 16.1, 16.3, 16.4 and 16.10
- Section 17 *Property, Plant and Equipment* – paragraph 17.1(a)

Investment property within a group

To address implementation issues, the FRC have included an accounting policy choice in situations where a group rents property out to other group members.

FRS 102, Section 16 *Investment Property* requires investment property to be measured at fair value at each reporting date with changes in fair value going through profit or loss. Under previous UK GAAP, SSAP 19 *Accounting for investment properties* contained a scope exemption for groups which meant that properties rented out, or occupied by, group members, were not investment property for the purposes of either the separate financial statements or the group accounts. This scope exemption was not carried over into FRS 102 resulting in such properties having to be measured at fair value through profit or loss. Where group accounts are prepared, the fair value exercise was reversed and the property was reclassified as owner-occupied property to reflect the fact that group accounts reflect the economic substance of the group, which is that of a single reporting entity; hence all intra-group issues are eliminated.

To address this problem, the FRC have included paragraphs 16.4A and 16.4B in FRS 102 (March 2018) which offer an accounting policy choice. Property rented out to other group members can either be accounted for at fair value through profit or loss; or by using the cost model (cost less depreciation less impairment) in Section 17 *Property, Plant and Equipment*. It is expected that the latter model will be the most popular as this effectively restores the position in previous UK GAAP for groups.

It is emphasised that this accounting policy option only relates to **investment property rented to another group entity**. It does not apply to non-group investment property which must be measured at fair value through profit or loss at each balance sheet date (even for small companies).

Directors' loans

The benchmark treatment for basic loans is outlined in Section 11 *Basic Financial Instruments*. Where loans are 'off-market rate' (i.e. at below market rates of interest or at zero rates of interest), the loan is discounted using a market rate of interest for a similar debt instrument. In practice, this has proved arduous for small entities. Loans which are unstructured (i.e. contain no formal loan terms) are treated as being repayable on demand and hence are treated as current with no discounting needed.

On 8 May 2017, the FRC issued a Press Notice announcing an immediate relief which was to come into effect for small entities with 31 December 2016 year ends onwards. This Press Notice confirmed that loans to a small company from a director-shareholder can be measured at transaction price (i.e. cost) rather than at present value. The triennial review extends this exemption slightly so that it also covers loans to a small company from a small group of the director's close family, provided there is a shareholder in that small group (the term 'close members of the family of a person' is a defined term in the glossary). Hence, loans to small entities from a director's group of close family members (including the director) will qualify for the relief from discounting if that group also includes a shareholder in the entity. The shareholder must be a natural person, so loans from corporate shareholders will not qualify. Loans to small entities from a director who is not a shareholder, and has no close family members which are shareholders, will not qualify for the exemption.

The relief is also available to LLPs. For LLPs, the term 'director' should be read as 'member' and the latest edition of the LLP SORP acknowledges that this relief is now available to small LLPs.

The exemption does not apply to loans to a director from the small company, nor does it apply to intra-group loans.

It must also be noted that where a director-shareholder, or close family member of that director-shareholder, provides a material loan to the small entity at below market or at zero rates of interest, the loan is caught by the related party disclosure requirements in FRS 102, paragraph 1AC.35 and therefore the loan must be disclosed as a related party transaction in the small entity's financial statements as it has not been concluded under normal market conditions.

Gift aid

Diversity in practice was emerging where a charitable parent had a trading subsidiary which made gift aid payments. In law, a gift aid payment is a distribution for accounting purposes, but a donation for tax purposes. Issues arose where there was no Deed of Covenant in place. Where a Deed of Covenant was in place, the treatment was less of an issue because the Deed of Covenant creates a liability for the trading subsidiary to make the gift aid payment at the year end, even if payment is made after the year end.

Gift aid payments are to be recognised as a distribution to owners as they are similar to dividends (i.e. they are recognised in equity). Similar principles to dividends also exist in respect of gift aid payments which are made after the balance sheet date. An expected gift aid payment must not be accrued unless there is a legal obligation to make the payment at the balance sheet date. A board decision to make a gift aid payment to a charitable parent prior to the balance sheet date is not sufficient to create a legal obligation.

When a subsidiary does not have a legal obligation to make a distribution of its profits to its owners at the balance sheet date, it will have taxable profits and hence will need to recognise an associated tax expense because FRS 102, paragraph 29.14 prohibits the tax effects of dividends being recognised before the dividend itself has been recognised.

FRS 102, paragraph 29.14A states that when it is probable (i.e. more likely than not) that a gift aid payment will be made within nine months of the reporting date to the same charitable

group, or charitable venturer, and the payment will qualify to be set against profits for corporation tax purposes, the tax effects of the gift aid payment can be accrued. The gift aid payment itself cannot be accrued unless there is a legal obligation.

Gift aid payments are recognised within equity and the tax effects are recognised in profit or loss.

Fair value guidance

The fair value guidance which was contained in FRS 102, paragraphs 11.27 to 11.32 has been moved into the Appendix to Section 2 *Concepts and Pervasive Principles*.

Micro-entities

Micro-entities in the Republic of Ireland can now apply FRS 105 for periods starting on or after 1 January 2017. Early adoption is permissible provided the Companies (Accounting) Act 2017 is applied from the same date.

For micro-entities in the UK, there are two additional disclosure requirements which are to be made at the foot of the balance sheet as follows:

- Information about off-balance sheet arrangements as required by section 410A of the Act; and
- Information about employee numbers as required by section 411 of the Act.

The additional disclosures above apply for periods starting on or after 1 January 2017. They are a legal requirement and hence should have been included in financial statements for periods starting on or after 1 January 2016, but were omitted in the July 2015 edition of FRS 105. The disclosures are included as a result of amendments made by The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980). SI 2015/980 made amendments to sections 410A and 411 of the Companies Act 2006 by removing the phrase *'In the case of a company that is not subject to the small companies' regime*'. This meant that all companies must disclose off-balance sheet arrangements and employee numbers.

Micro-entities must also disclose the information required by s396(A1) as follows:

- The part of the UK in which the company is registered;
- The company's registered number;

- Whether the company is a public or a private entity and whether it is limited by shares or by guarantee (note: as micro-entities cannot be public companies, such entities will always be private entities);
- The address of the company's registered office; and
- Where appropriate, the fact that the company is being wound up.

Micro-entities in the Republic of Ireland

Micro-entities in the Republic of Ireland adopting FRS 105 as their financial reporting framework are required to disclose more comprehensive information than micro-entities in the UK. In addition, the notes are included in a separate 'Notes to the financial statements' section rather than at the foot of the micro-entity's balance sheet. FRS 105, Section 6 *Notes to the Financial Statements* has been amended to include Appendix B *Company law disclosure requirements for micro-entities in the Republic of Ireland* which is an integral part of Section 6 and must be applied by micro-entities in the Republic of Ireland.

FREQUENTLY ASKED QUESTIONS FOR SMALL COMPANIES

I have a client with a portfolio of investment properties which we have always depreciated. Do they have to be measured at fair value under FRS 102?

Investment property has always had to be revalued. Under previous UK GAAP, SSAP 19 *Accounting for Investment Properties* and the FRSSE such properties had to be revalued to open market value at each balance sheet date. There were no exemptions for any companies, other than group members letting out, or occupying, property.

There is an accounting policy choice in FRS 102 (March 2018) which allows intra-group investment property (i.e. property rented out to another group member) to be measured at fair value through profit or loss or under the cost model (i.e. at cost less depreciation less impairment per Section 17).

All non-intra-group investment property under FRS 102 must be remeasured to fair value at each balance sheet date with changes in fair value passing through profit or loss. There are no exceptions to this rule and there are no 'undue cost or effort' exemptions in the March 2018 edition of FRS 102. If this accounting treatment has not been applied, it is likely to be a material error which must be corrected by way of a prior year adjustment under the provisions of Section 10 *Accounting Policies, Estimates and Errors*.

I have a client that has never amortised goodwill under its previous financial reporting framework. Can this continue under FRS 102?

Goodwill under FRS 102 can never have an indefinite useful life (FRS 102, paragraph 19.23(a)). Where goodwill has not been amortised under the client's previous financial reporting framework, it must be amortised from the date of transition onwards under FRS 102. Where management are unable to reliably estimate the useful economic life of goodwill, the amortisation period must not exceed 10 years. This 10-year 'cap' is not a minimum period and the reporting entity may judge a period shorter than 10 years to be appropriate in the circumstances.

The majority of my clients are small companies. My accounts production software does not bring the directors' remuneration and other benefits disclosure through under FRS 102. Is this right?

The requirement for small companies to disclose directors' remuneration and other benefits was repealed by SI 2015/980 and took mandatory effect for accounting periods starting on

or after 1 January 2016. However, where directors' remuneration is not being paid under normal market conditions, then it will be disclosable as a related party transaction; where the directors' remuneration is concluded to be being paid under normal market conditions, disclosure is not required. Most small companies pay directors who are also shareholders a mixture of salary (usually up to the PAYE threshold) with the balance of remuneration paid in dividends. Whether the directors view this arrangement as 'normal market conditions' will be entity-specific. It is advisable to document all judgements and conclusions where subjective areas such as this are concerned.

Is the statement of changes in equity required to be filed at Companies House for my small company clients where I file filleted accounts? I have heard different views on this.

The filing requirements for small companies are contained in section 444 of the Companies Act 2006 (the Act). According to s444(1) of the Act, the directors of a company subject to the small companies regime *must* deliver a copy of the balance sheet as at the last day of the year. The small company *may* also deliver a copy of the company's profit and loss account and a copy of the directors' report. In ACCA's view, the statement of changes in equity is not required to be filed at Companies House where the small entity may be filing filleted accounts.

The statement of changes in equity (SoCIE) would be required in order for the financial statements to give a true and fair view. Hence, ACCA would require member firms to include a copy of the SoCIE where doing so would enable a true and fair view. The SoCIE need only be included in the financial statements prepared for the shareholders and HM Revenue and Customs (i.e. the 'full' not 'filleted' accounts). The SoCIE would, therefore, be required where the company has paid dividends to shareholders as dividends in a small company are invariably material.

Is the average number of employees required to be disclosed in the filleted accounts for Companies House?

ACCA member firms must include the average number of employees disclosure. This is because this disclosure informs users as to how many employees the business has employed, on average, during the year. It is not a payroll disclosure, i.e. a profit and loss account item and therefore must not be filleted out.

I have heard the operating lease disclosure is different under FRS 102 compared to previous UK GAAP but I am struggling to understand how?

Under previous UK GAAP, companies were only required to disclose the total commitments under operating leases falling due within the next 12 months from the balance sheet date. For example, if an operating lease had three years' left to run and in the next financial year the company was to pay £6,000 to the lessor, the commitment of £6,000 would be disclosed in the operating leases falling due within more than one year but less than five years time-band.

Under FRS 102, the total outstanding commitment in the lease at the balance sheet date is disclosed. Therefore, using the example above, the operating lease would be disclosed as:

Amount falling due within one year:	£6,000
Amount falling due after more than one year but less than five years:	£12,000

The aim of the disclosure under FRS 102 is to make it more transparent as to what the company is committed to under the operating lease.

How often must a company revalue a building under the revaluation model?

FRS 102 requires valuations to be carried out with *sufficient regularity* to ensure that the carrying amount in the financial statements does not materially differ from the building's fair value. The standard does not prescribe specific timescales to obtain revaluations. If the building's fair value fluctuates regularly, revaluations may be required on a regular basis; whereas if they do not fluctuate regularly, revaluations will be carried out on an infrequent basis. Professional judgement will be needed where this is concerned.

TRANSITION TO FRS 102

For the vast majority of small entities, the transition to FRS 102 will have taken place for an accounting period starting on or after 1 January 2016 (ie December 2016 year-ends). However, that is not to say that all transitions to FRS 102 need be forgotten about. A micro-entity could transition up from FRS 105 to FRS 102 or from FRS 101 *Reduced Disclosure Framework* to FRS 102.

As with companies outside of the small companies regime, a small entity transitioning to FRS 102 must apply the rules in FRS 102 retrospectively to the date of transition and apply the principles in Section 35 *Transition to this FRS* on first-time adoption of FRS 102. Other than presentation and disclosure requirements if the small entity applies Section 1A, the same recognition and measurement principles will be applied by small companies as medium-sized and large entities will apply under FRS 102.

The objective of this restatement process is so that the financial statements reflect the provisions in FRS 102 as if the standard had always been the framework used by the entity. Retrospective application will enable the financial statements to be both comparable and consistent because otherwise it would be meaningless to have the current year's financial statements prepared under FRS 102, with the previous period prepared under, say, FRS 105 where the entity has outgrown FRS 105 and is now moving up to FRS 102. Retrospective restatement is needed as far back as the date of transition so that the opening balances, on which the comparative year is built, reflect the provisions in FRS 102.

A first-time adopter must apply Section 35 in the first set of financial statements that comply with FRS 102. An entity's 'first set of financial statements that comply with FRS 102' are those that contain an *explicit and unreserved* statement of compliance with FRS 102, where the small entity provides this encouraged statement to comply with FRS 102, paragraph 1AE.1(a). FRS 102, paragraph 35.4 provides three examples of when financial statements prepared under the principles of FRS 102 are an entity's first such financial statements as follows (note (b) below reflects the amendment made as part of the triennial review):

a. the entity did not present financial statements for previous periods,
b. the entity presented its most recent previous financial statements under previous UK and Republic of Ireland requirements that are not consistent with FRS 102 in all respects, or

c. the entity presented its most recent previous financial statements in conformity with EU-adopted IFRS.

The standard requires an entity to disclose comparative information in respect of the previous accounting period for all amounts presented in the financial statements and specified comparative narrative and descriptive information. The majority of reporting entities in the UK and Republic of Ireland will provide current year financial information and the previous period's/year's comparatives; however, the standard does permit an entity to present more than one preceding period (although in practice this is not usually done).

Where an entity is applying FRS 102 for the first time and only presents one preceding period of comparative information, the entity will need to make adjustments to:

- the comparative statement of financial position (balance sheet);
- the comparative income statement/statement of comprehensive income (profit and loss account/other comprehensive income statement); and
- the opening statement of financial position (balance sheet) at the date of transition (although this is not disclosed in the financial statements).

The transition procedures can be looked at as a stage of five steps:

Step 1: determine the date of transition

Step 2: recognise all assets and liabilities whose recognition is required by FRS 102

Step 3: derecognise items as assets or liabilities if FRS 102 does not permit such recognition

Step 4: reclassify items that it recognised under its previous financial reporting framework as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under FRS 102

Step 5: apply FRS 102 in measuring all recognised assets and liabilities

Transitional versus prior period adjustments

It should be noted that the accounting policies which an entity uses in its opening balance sheet under FRS 102 could differ from those that it used as at the same date under its previous framework. This is because the entity's previous framework may have permitted certain accounting treatments, whereas FRS 102 may not permit such accounting treatments, and vice versa. Any adjustments that are made to the entity's opening balance

sheet position as a result of aligning accounting policies to achieve compliance with FRS 102 are generally referred to as 'transitional adjustments'.

This is particularly the case when an entity transitions from FRS 105 to FRS 102. There are no accounting policy options available to micro-entities choosing to report under FRS 105. When the micro-entity outgrows FRS 105, or chooses to report under FRS 102 instead, more accounting policy options are available and this is likely to have an impact on the financial statements which are likely to need restatement to comply with FRS 102 principles on first-time adoption of the standard. In addition, more comprehensive disclosure requirements need to be made in the financial statements.

With the exception of some specified exceptions and exemptions, the rules must be applied to the prior period comparative financial statements and these adjustments are generally referred to as 'prior period adjustments'. It is important to distinguish between the two types of adjustments. Some examples of adjustments that might be made to a category of equity, other than retained earnings, include:

- amounts in respect of remeasuring derivative financial instruments that are subject to hedge accounting under Section 12 *Other Financial Instruments Issues*;
- any difference between the cost of an item of property, plant and equipment and fair value where the entity uses a deemed cost, or where a policy of revaluing the asset(s) is adopted on transition to FRS 102; and
- deferred tax that is recognised for the first time on items of property, plant and equipment measured under the revaluation model and that has been included in the same reserve as the revaluation gain.

Determining the date of transition

The date of transition is the start date of the earliest period reported in the financial statements.

Example 1: determining the date of transition

Company A Ltd is preparing its first set of FRS 102 financial statements for its year ended 31 March 2019 (it previously reported under FRS 105) and the financial controller is unsure as to the entity's date of transition. The company only includes the preceding year's financial statements as comparatives.

The date of transition is the start date of the earliest period reported in the accounts. The comparative year ended on 31 March 2018 and it started on 1 April 2017; therefore 1 April 2017 is the entity's date of transition.

Company B Ltd is preparing its first set of FRS 102 financial statements for its year ended 31 July 2019 (it also previously reported under FRS 105) and the accounts senior is unsure as to the entity's date of transition. The company only includes the preceding year's financial statements as comparatives.

In Company B's case, the date of transition will be 1 August 2017, being the start date of the earliest period reported in the financial statements.

Mandatory exceptions from retrospective application

FRS 102, paragraph 35.9 prohibits a first-time adopter from retrospectively changing the accounting that it followed under its previous GAAP for any of the following types of transactions:

- **Derecognition of financial assets and financial liabilities**
  Where financial assets and financial liabilities were derecognised under the entity's previous financial reporting framework prior to the date of transition, they are not to be recognised on transition to FRS 102. Also, where a financial asset or a financial liability (or group of financial assets and financial liabilities) would have been derecognised under FRS 102 in a transaction which took place prior to the date of transition, but which has not been derecognised under its previous financial reporting framework, the entity can either derecognise them on adoption of FRS 102, or continue to recognise them until they are either disposed of or settled.
- **Accounting estimates**
  Accounting estimates at the date of transition cannot be changed for the benefits of hindsight. Therefore, if the reporting entity had a provision for liabilities at its date of transition, but now knows the outcome of the event or condition that gave rise to that provision, it cannot retrospectively change the amount of the estimate.
- **Measuring non-controlling interests (often referred to as 'minority interests')**
  The entity must not retrospectively change the accounting that it followed under its previous reporting framework for measuring non-controlling interests. The requirements to:

- allocate profit or loss and total comprehensive income between non-controlling interests and owners of the parent,
- account for changes in the parent's ownership interest in a subsidiary which do not result in a loss of control, and
- account for a loss of control over a subsidiary,

must be applied **prospectively** from the date of transition to FRS 102, or from such earlier date as FRS 102 is applied to restate business combinations (see the next section of this technical factsheet, 'Optional exemptions from retrospective application').

Optional exemptions from retrospective application

FRS 102, paragraph 35.10 contains 21 **optional** exemptions from retrospective application of FRS 102, which a first-time adopter may wish to take advantage of in its first set of FRS 102 financial statements.

Small entities have an additional three optional exemptions available to them in respect of:

- share-based payment transactions;
- fair value measurement of financial instruments; and
- financing transactions involving related parties.

These three additional operational exemptions for small entities were only available to small entities transitioning to FRS 102 for accounting periods starting **before** 1 January 2017. This was to address potential issues arising from a short implementation period following the implementation of the EU Accounting Directive.

In respect of the optional exemptions, a small entity can take advantage of all, some or none of them as applicable. In the vast majority of cases, it is unlikely that a small entity will be able to take advantage of all of the optional exemptions.

- **Business combinations, including group reconstructions**
  A first-time adopter does not have to apply Section 19 *Business Combinations and Goodwill* to those business combinations that took place *before* the date of transition. However, where the entity restates any business combination so as to comply with Section 19, it must restate all later business combinations. Where the provisions in Section 19 are not applied retrospectively, all assets and liabilities acquired or assumed in a past business combination at the date of transition will be recognised and measured

in accordance with FRS 102, paragraphs 35.7 to 35.9 (or, if applicable, paragraphs 35.10(b) to (v)). There are, however, two exceptions in respect of:

- intangible assets (not goodwill): intangible assets subsumed within goodwill should not be recognised separately; and
- goodwill: no adjustment is made to the carrying amount of goodwill.

- **Share-based payment transactions**

  For equity instruments granted *before* the date of transition, a first-time adopter does not have to apply Section 26 *Share-based Payment*. This exemption also applies to liabilities arising from share-based payment transactions that were settled prior to the date of transition.

  Where a first-time adopter has previously applied either FRS 20 *Share-based payment*, or IFRS 2 *Share-based Payment*, to equity instruments granted BEFORE the date of transition, the entity must then apply FRS 20/IFRS 2 (as applicable) or Section 26 at the date of transition.

  - **Share-based payment transactions for small entities**

    For a small entity that first adopts FRS 102 for an accounting period starting **before 1 January 2017**, this exemption is extended to equity instruments that were granted before the start of the first reporting period that complies with FRS 102, provided that the small entity did not previously apply FRS 20 or IFRS 2. Where a small entity chooses to apply this exemption, it must provide disclosures in accordance with FRS 102, paragraph 1AC.31, which relates to off-balance sheet arrangements.

- **Fair value as deemed cost**

  For items of property, plant and equipment (Section 17 *Property, Plant and Equipment*), investment property (Section 16 *Investment Property*) or intangible assets excluding goodwill (Section 18 *Intangible Assets other than Goodwill*), a first-time adopter can use fair value as deemed cost on transition to FRS 102. The term 'deemed cost' is defined in the glossary as:

  *'An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent **depreciation** or **amortisation** assumes that the entity had initially recognised the **asset** or **liability** at the given date and that its cost was equal to the deemed cost.'*

- **Revaluation as deemed cost (see example 2 below)**
  Again, for items of property, plant and equipment, investment property or intangible assets other than goodwill, a first-time adopter can use a revaluation amount as deemed cost. This may be of particular benefit to a client who wants to stop getting periodic revaluations and move back onto the cost model for its property, plant and equipment (although the entity must still present a revaluation reserve on its balance sheet as it will be using a previous revaluation amount as deemed cost). Care must be taken with this exemption because the valuations used as deemed cost should be either at the date of transition or before the date of transition, **but not after**.

- **Individual and separate financial statements**
  FRS 102, paragraph 9.26, 14.4 and 15.9 require an entity to account for investments in subsidiaries, associates and jointly controlled entities either at cost less impairment or at fair value in the individual or separate financial statements. Where cost is used, the first-time adopter must use one of the following amounts in the individual/separate opening balance sheet:

  - cost per Section 9 *Consolidated and Separate Financial Statements*, Section 14, *Investments in Associates* or Section 15 *Investments in Joint Ventures*; or
  - deemed cost – in this respect the deemed cost is the carrying amount at the date of transition which has been determined under its previous reporting framework.

- **Compound financial instruments**
  'Split accounting' is used for compound financial instruments (where the debt and equity components of the instruments are accounted for separately). A first-time adopter does not have to use split accounting if the liability portion of the instrument has been settled at the date of transition.

- **Service concession arrangements**
  A service concession arrangement is defined in the glossary as:

  *'An arrangement whereby a public sector body or a **public benefit entity** (the grantor) contracts with a private sector entity (the operator) to construct (or upgrade), operate and maintain **infrastructure assets** for a specified period of time (the concession period).'*

For such arrangements, a first-time adopter does not have to apply the provisions in FRS 102, paragraphs 34.12I to 34.16A for service concession arrangements entered into prior to the date of transition as these arrangements will continue to be accounted for using the same accounting policies applied at the date of transition.

- **Extractive industries**
  Where a first-time adopter has previously accounted for exploration and development costs for oil and gas properties that are in the development/production phase in cost centres that included all properties in a large geographical area, it can choose to measure oil and gas assets at the date of transition on the following basis:

  - exploration and evaluation assets at the amount determined under its previous reporting framework
  - assets in the development/production phase at the amount determined for the cost centre under its previous reporting framework. (This amount will be allocated to the cost centre's underlying assets on a pro-rata basis using reserve volumes or values at the date of transition.)

  First-time adopters must test exploration and evaluation assets in the development and production phases for impairment at the date of transition in accordance with either Section 34 *Specialised Activities* or Section 27 *Impairment of Assets*.

- **Arrangements containing a lease**
  First-time adopters can choose to determine whether an arrangement that exists at the date of transition contains a lease on the basis of facts and circumstances existing at the date of transition, rather than when the lease was originally entered into.

- **Decommissioning liabilities included in the cost of property, plant and equipment (PPE)**
  The cost of an item of PPE should include the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. A first-time adopter can choose to measure this portion of the cost at the date of transition rather than on the date(s) when the obligation initially arose.

- **Dormant companies**

  A company that is dormant (as defined in the Companies Act 2006) can retain its accounting policies for reported assets, liabilities and equity at the date of transition until such time that there is a change to those balances or the company enters into new transactions.

- **Deferred development costs as deemed cost**

  The carrying amount of development costs capitalised under the entity's previous reporting framework can be used as deemed cost on transition to FRS 102.

- **Lease incentives (see example 3 below)**

  A first-time adopter does not have to apply FRS 102, paragraphs 20.15A and 20.25A to lease incentives provided that the lease was entered into before the date of transition. The first-time adopter can continue to recognise any remaining lease incentive (or cost associated with lease incentives) on the same basis as that applied at the date of transition to FRS 102.

- **Public benefit entity combinations**

  A first-time adopter does not have to apply paragraphs PBE34.75 to PBE34.86 to public benefit combinations that had taken place prior to the date of transition. However, if the first-time adopter restates any entity combination to comply with FRS 102, it must restate all later entity combinations.

- **Assets and liabilities of subsidiaries, associates and joint ventures**

  When a subsidiary becomes a first-time adopter later than its parent, the subsidiary measures its assets and liabilities at either:

  1. the carrying values that would be included in the parent's consolidated accounts. These values are based on the parent's date of transition to FRS 102 if no consolidation adjustments were made and for the effects of the business combination in which the parent acquired the subsidiary; or
  2. the carrying values required by the rest of FRS 102, which are based on the subsidiary's date of transition.

  The carrying values in 2 could be different from in 1 where the exemptions result in measurements that are dependent on the date of transition. In addition, differences could

arise where the accounting policies used by the subsidiary differ from those in the consolidated accounts.

Similar exemptions are available for an associate or joint venture that become a first-time adopter later than the entity that holds significant influence or joint control over it.

Conversely, where the parent or investor becomes a first-time adopter later than its subsidiary, associate or joint venture, the parent/investor will, in the consolidated financial statements, measure the assets and liabilities of the subsidiary, associate or joint venture at the same carrying value as in the subsidiary's, associate's or joint venture's financial statements. This takes into account consolidation and equity accounting adjustments as well as the effects of the business combination in which the parent acquired the subsidiary or transaction in which the entity acquired the associate or joint venture.

Where the parent becomes a first-time adopter in respect of its separate financial statements earlier or later than for its consolidated accounts, the parent measures its assets and liabilities at the same value in both sets of accounts, except for consolidation adjustments.

- **Designation of previously recognised financial instruments**
  FRS 102 allows a financial instrument to be designated on initial recognition as a financial asset or financial liability at fair value through profit or loss, provided certain criteria are met. A first-time adopter can designate any financial asset or financial liability at fair value through profit or loss provided that the asset or liability meets the criteria in FRS 102, paragraph 11.14(b) at the date of transition.

- **Hedge accounting**
  There are exemptions available in respect of hedge accounting that may be applied in respect of:

  - a hedging relationship existing at the date of transition
  - a hedging relationship which ceased to exist at the date of transition because the hedging instrument had expired, was sold, terminated or exercised prior to the date of transition
  - a hedging relationship which commenced subsequent to the date of transition

- entities that choose to take the accounting policy choice under FRS 102, paragraphs 11.2(b) or (c), or paragraphs 12.2(b) or (c), and apply IAS 39 *Financial Instruments: Recognition and Measurement*, or IFRS 9 *Financial Instruments*.

- **Small entities – fair value measurement of financial instruments**
  A small entity that adopts FRS 102 for an accounting period starting **before 1 January 2017** does not need to restate comparative information to comply with the fair value measurement requirements of Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues*, unless those instruments were measured at fair value under its previous financial reporting framework. A small entity that chooses to present comparative information which does not comply with the fair value measurement requirements of Sections 11 and 12 in its first year of adoption must:

  a. apply its existing accounting policies to the relevant financial instruments in the comparative information and is encouraged to disclose this fact;

  b. disclose the accounting policies applied (in accordance with paragraph 1AC.3); and

  c. treat any adjustment between the statement of financial position at the comparative period's reporting date and the statement of financial position at the start of the first reporting period that complies with Sections 11 and 12 as an adjustment, in the current reporting period, to opening equity.

- **Small entities – financing transactions involving related parties**
  A small entity that first adopts FRS 102 for an accounting period which starts **before 1 January 2017** is not required to restate comparative information to comply with the requirements of FRS 102, paragraph 11.13 only insofar as they relate to financing transactions involving related parties.

  A small entity that chooses to present comparative information which does not comply with the financing transaction requirements of Section 11 in its first year of adoption must:

  a. apply its existing accounting policies to the relevant financial instruments in the comparative information and is encouraged to disclose this fact;

  b. disclose the accounting policies applied (in accordance with paragraph 1AC.3); and

c. treat any adjustment between the statement of financial position at the comparative period's reporting date and the statement of financial position at the start of the first reporting period that complies with FRS 102, paragraph 11.13 as an adjustment, in the current reporting period, to opening equity. The present value of the financial asset or financial liability at the start of the first reporting period that complies with FRS 102 may be determined on the basis of the facts and circumstances, which exist at that date, rather than the date on which the arrangement was entered into.

Example 2: revaluation as deemed cost

Under its previous financial reporting framework, Company A Ltd always measured its freehold buildings under the revaluation model and obtained up-to-date valuations where evidence suggested that there had been a material change in value.

The board of directors have decided that the use of the revaluation model is no longer appropriate for the business and have enquired as to whether they can measure the freehold buildings using the historic cost model.

Under the entity's previous financial reporting framework, a change from the depreciated historic cost model to the revaluation model would have been classed as a change in accounting policy (as it would be under FRS 102 principles). An accounting policy is changed by an entity only when that change results in the financial statements providing reliable and more relevant information and it is generally accepted that regular valuations are more reliable than the cost model. In view of this principle, it is inherently difficult to switch back from the revaluation model to the cost model because an entity would struggle to justify how the cost model provides reliable and more relevant information over up-to-date valuations.

However, in Company A's situation, the company is transitioning to a whole new financial reporting framework and hence it is possible to use a revalued amount as deemed cost (as per FRS 102, paragraph 35.10(d)), provided that the date of the valuation is either at, or before, the date of transition. GAAP valuations cannot be obtained after the date of transition and then be used as deemed cost. Advance planning is advisable where an entity wishes to take advantage of revaluations as deemed cost to ensure an appropriate valuation is obtained.

Example 3: lease incentive restatement

Company B Ltd enters into a 10-year lease to occupy a commercial building on 1 January 2012. Annual rentals amount to £100,000 and the landlord has agreed to a one-year rent-free period. The terms of the lease provide for a break-clause at the end of year five, after which rental payments are to revert to market rate. Company B has an accounting reference date of 31 December and its date of transition is 1 January 2015.

Under previous UK GAAP the lease incentive would be amortised up to the point at which lease rentals revert to market rate (ie from years six to 10), hence the lease profile would be as follows:

	Paid	**Charge to P&L**	**Balance c/f**
Year end	**£'000**	**£'000**	**£'000**
31.12.2012	-	80	80
31.12.2013	100	80	60
31.12.2014	100	80	40
31.12.2015	100	80	20
31.12.2016	100	80	-

Option 1: restate the lease incentive to comply with FRS 102 principles

FRS 102, Section 20 *Leases* does not consider break clauses and instead requires lease incentives to be written off *over the term of the lease*. Therefore, under FRS 102, the lease profile would be as follows:

	Paid	**Charge to P&L**	**Balance c/f**
Year end	**£'000**	**£'000**	**£'000**
31.12.2012	-	90	90
31.12.2013	100	90	80
31.12.2014	100	90	70
31.12.2015	100	90	60
31.12.2016	100	90	50
31.12.2017	100	90	40
31.12.2018	100	90	30
31.12.2019	100	90	20
31.12.2020	100	90	10
31.12.2021	100	90	-

To restate the lease incentive to FRS 102, the transitional adjustment at 1 January 2015 is as follows:

Dr Retained earnings	£30k
Cr Balance sheet incentive	£30k

Being the difference between £70k at 31.12.2014 under FRS 102 and £40k under previous UK GAAP

The journal above would restate the lease incentive in the opening FRS 102 balance sheet to what it would have been had FRS 102 always been the financial reporting framework, with the corresponding entry being taken to retained earnings (reserves) as per FRS 102, paragraph 35.8.

Option 2: continue with previous UK GAAP treatment

Company B can continue to amortise the lease incentive up to the point at which rentals revert to market rate (ie up to the end of year five). This exemption is available for leases that have been entered into prior to the date of transition to FRS 102.

TRANSITION TO FRS 102: WORKED EXAMPLE

Smallco Ltd is preparing its first set of FRS 102 financial statements for the year ended 30 April 2019 having previously reported another financial reporting framework. The date of transition is 1 May 2017 and the opening balance sheet position as at that date is shown below:

Smallco Ltd

Trial balance as at 1 May 2017

	Note	Dr	Cr
		£	£
Plant and machinery		104,801	
Plant and machinery depreciation			34,926
Fixtures and fittings		308,987	
Fixtures and fittings depreciation			158,604
Investment property	1	206,650	
Stock		11,383	
Trade debtors		650,114	
Prepayments		15,649	
Interest-free loan to subsidiary company	2	15,000	
Cash at bank and in hand		850,669	
Trade creditors			75,864
Corporation tax			16,300
Sundry creditors			8,546
Accrued expenses	3		16,200
Director's current account due after more than one year	4		65,000
Deferred tax			9,164
Share capital			100
Revaluation reserve			85,200
Retained earnings			1,693,349
		2,163,253	2,163,253

Notes

1. The investment property was previously accounted for under a framework which required revaluation gains and losses to be presented within a revaluation reserve. The investment property is to be measured under the fair value model in Section 16 *Investment Property*. The directors do not wish to recognise a separate reserve in respect of non-distributable reserves and the directors do not anticipate selling the investment property in the foreseeable future.

2. There are no formal loan terms attached to the loan to the subsidiary company.

3. Smallco's holiday year is not coterminous with its year end. The payroll clerk has calculated that an amount of £7,200 was due to employees at the year end 30 April 2017 in respect of accrued holiday pay. The company's previous financial reporting framework did not require accruals for unpaid holiday entitlement.

4. The director's loan account represents funds introduced by the director who is also the majority shareholder of the business. The director does not consider the loan to be repayable in the foreseeable future and the loan has been classed as long-term which was permitted under the entity's previous financial reporting framework. There are no formal terms attached to the loan and no interest payments are made to the director.

FRS 102, paragraph 35.7 says that an entity shall, in its opening statement of financial position (balance sheet), as at the date of transition:

a. recognise all assets and liabilities whose recognition is required by this FRS;

b. not recognise items as assets or liabilities if this FRS does not permit such recognition;

c. reclassify items that it recognised under its previous financial reporting framework as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under this FRS; and

d. apply this FRS in measuring all recognised assets and liabilities.

The entity is required to consider its accounting policies and determine whether they are compliant with the requirements of FRS 102. Where such policies may have been permissible under the entity's previous financial reporting framework, but are not permissible under FRS 102, they must be changed retrospectively at the date of transition as well as in the comparative financial statements.

In Smallco's case, there are four matters which must be dealt with at the date of transition in order that the opening balance sheet position at the date of transition is compliant with FRS 102. These are dealt with as follows:

1. Investment property

The investment property was previously carried at open market value at each balance sheet date under its previous financial reporting framework. Gains and losses in respect of this investment property were taken to the revaluation reserve within equity. The accounting treatment for such properties is different under FRS 102, because all fair value gains and losses must be reported within profit or loss as FRS 102 uses the fair value accounting rules. (Note: FRS 102 does not recognise the concept of 'operating profit' even though it is acceptable to use an 'operating profit' line item on the face of the profit and loss account. Such gains and losses should be regarded as operating gains/losses.)

It is worth noting that the treatment of fair value gains and losses **only differs in respect of investment property**. Items of property, plant and equipment which are measured under the revaluation model in Section 17 are accounted for under the alternative accounting rules in UK company law and gains are recognised in the revaluation reserve. Gains are only recognised in profit or loss to the extent they reverse a previously recognised revaluation loss in respect of that asset. Losses are recognised in the revaluation reserve to the extent of a surplus on the revaluation reserve in respect of that asset with any remaining loss taken to profit and loss.

The transitional adjustments needed are as follows:

	£
Dr Revaluation reserve	85,200
Cr Retained earnings	85,200

Being reallocation of revaluation reserve in respect of the investment property

Where transitional adjustments are concerned, corresponding entries are taken to profit and loss account reserves (retained earnings) as per FRS 102, paragraph 35.8.

Note: an alternative treatment would be to rename the revaluation reserve 'non-distributable reserve' to ring-fence those gains that are not available for distribution to the shareholders. There is nothing in company law that requires this treatment, but it may be advisable to have a separate reserve to take unrealised gains to prevent them from being inappropriately distributed to shareholders.

In addition, FRS 102, paragraph 29.16 requires deferred tax to be brought into consideration where investment properties are concerned to comply with Section 29 *Income Tax*. The

directors do not envisage selling the investment property in the foreseeable future and paragraph 29.16 requires deferred tax in respect of investment property to be measured using the tax rates and allowances that apply to the sale of the asset. Therefore, if it is assumed the tax rate which will apply to the sale is 17% (which will be the corporation tax rate for the corporation tax year starting on 1 April 2020 and was announced in the Summer Budget 2015), deferred tax, excluding the effects of indexation which may be available, is recognised on the investment property at the date of transition as follows:

	£
Dr Retained earnings	14,484
Cr Deferred tax provision	14,484

Being deferred tax on the investment property revaluation (£85,200 x 17%)

Note: if Smallco Ltd were to recognise non-distributable reserves in a separate reserve, the debit would have been taken to that specific reserve. The concept of 'tax treatment follows accounting treatment' applies in respect of deferred tax.

The net gain of £70,716 (£85,200 less £14,484) must not be distributed to shareholders because it is an unrealised gain. Gains only become realised gains when they are readily convertible into cash, and a fair value gain on investment property is not readily convertible into cash.

2. Interest-free loan to subsidiary company

There are no specific terms attached to the loan made to the subsidiary company.

As there are no specific terms attached to this loan, the default presumption is that the loan is repayable on demand and hence it is to be treated as such in the balance sheet on transition, in the comparative year and going forward. While this may not be such an issue for Smallco, if the subsidiary had classified the loan as a long-term liability, it would have to move it up to current liabilities in its balance sheet. This will reduce the value of the subsidiary's net current assets, or turn net current assets into net current liabilities or even increase net current liabilities. This is an important planning point prior to the transition as reallocating loans from long-term to current may impact the company's credit rating and/or the views of lenders and creditors.

3. Holiday pay accruals

The holiday year at Smallco is not coterminous with its year end. It is not always advisable to align the holiday year with the financial year simply for financial reporting purposes. In situations where the holiday year is not aligned to the accounting reference date, holiday pay accruals will be needed to comply with the requirements of Section 28 *Employee Benefits*. It is also to be noted that it is possible that holiday pay *prepayments* might be recognised depending on where the entity's holiday year is in relation to the financial year.

In the example, the payroll clerk has calculated that an amount of £7,200 was due to employees as at 30 April 2017 and that this amount had not previously been recognised. Therefore, the holiday pay at the date of transition is recorded as follows:

	£
Dr Retained earnings	7,200
Cr Accruals	7,200

Being holiday pay accruals as at 30 April 2017

Tax implications have been ignored for the purposes of this example, but would be brought into account if the holiday pay accrual is paid within nine months of the year-end date (as corporation tax relief is granted in such situations).

4. Director's loan account

The director (who is also the majority shareholder) has made a loan to the business amounting to £65,000.

The loan has no formal terms attached to it but has been regarded as a long-term liability in previous accounting periods. In the absence of any specific terms, this treatment is not possible under FRS 102 because loans without specific terms attached would be regarded as being repayable on demand (in much the same way as the loan discussed in Note 2 above). A transitional adjustment is needed to reflect the on demand feature of the loan as follows:

	£
Dr Long-term liabilities	65,000
Cr Director's current account (current liabilities)	65,000

Being reallocation of director's current account

Had the loan been a financing transaction (i.e. provided at below market rates, or zero rates, of interest) and contained formal loan terms, for example stating that the loan is repayable in five years' time, it could be covered by the exemption in FRS 102, paragraph 11.13A(a) as it has been made by a director who is also a shareholder, the company is small and hence the loan does not need to be discounted.

Following the incorporation of the above transitional adjustments, Smallco's opening trial balance at the date of transition will look as follows:

Smallco Ltd
Trial balance as at 1 May 2017

	Dr	Cr
	£	£
Plant and machinery	104,801	
Plant and machinery depreciation		34,926
Fixtures and fittings	308,987	
Fixtures and fittings depreciation		158,604
Investment property	206,650	
Stock	11,383	
Trade debtors	650,114	
Prepayments	15,649	
Interest-free loan to subsidiary company	15,000	
Cash at bank and in hand	850,669	
Trade creditors		75,864
Corporation tax		16,300
Director's current account due within one year		65,000
Sundry creditors		8,546
Accrued expenses		23,400
Deferred tax		23,648
Share capital		100
Retained earnings		1,756,865
	2,163,253	2,163,253

Retained earnings have increased by £63,516 (£1,756,865 less £1,693,349) and this increase is reconciled as follows:

	£
Retained earnings under previous GAAP	1,693,349
Reallocation of revaluation reserve for investment property	85,200
	1,778,549
Additional deferred tax recognised on investment property	(14,484)
Holiday pay accrual	(7,200)
Retained earnings under FRS 102	1,756,865

Prior year adjustments

As financial statements will invariably include the previous year as comparative, those comparatives must also be restated so that they reflect the provisions in FRS 102. This will enable the financial statements to be comparable and consistent.

Continuing with the example of Smallco above, the trial balance as at 30 April 2018 prepared under the entity's previous financial reporting framework is shown below:

Smallco Ltd
Trial balance as at 30 April 2018

	Note	Dr	Cr
		£	£
Plant and machinery		104,801	
Plant and machinery depreciation			52,395
Fixtures and fittings		308,987	
Fixtures and fittings depreciation			235,851
Investment property	1	226,650	
Stock		13,002	
Trade debtors		632,114	
Prepayments		15,649	
Interest-free loan to subsidiary company	2	15,000	
Cash at bank and in hand		1,861,332	
Trade creditors			71,552
Corporation tax			164,664
Sundry creditors			8,546
Accrued expenses	3		23,400
Director's current account due after more than one year	4		65,000
Deferred tax			22,984
Share capital			100
Revaluation reserve			20,000
Retained earnings			1,756,865
Sales			4,126,211
Opening stock		11,383	
Purchases		2,574,327	
Closing stock			13,002
Freight		351,104	
Director's remuneration		18,012	
Employer NIC on director's remuneration		1,449	
Staff salaries		142,604	
Advertising		5,692	
Travelling		25,214	
Accountancy and bookkeeping		8,500	
Bank charges		2,334	
Depreciation charges		94,716	
Tax		147,700	
		6,560,570	6,560,570

Summary financial statements based on the above trial balance are as follows:

Balance sheet

	£	£
Fixed assets	352,192	
Current assets	2,537,097	
Liabilities		333,162
Provisions for deferred tax		22,984
Equity and reserves		2,533,143
	2,889,289	2,889,289

Profit and loss account

	£
Turnover	4,126,211
Cost of sales	(2,572,708)
Distribution costs	(351,104)
Administrative expenses	(298,521)
Profit before tax	903,878
Tax	(147,700)
Profit after tax	756,178

Adjustments will have to be made to the prior year balances so that they reflect the provisions in FRS 102 as follows:

Notes

1. Investment property

The investment property has seen a fair value gain as at 30 April 2018 of £20,000. The entries in the comparative year were:

Dr Investment property	£20,000
Cr Revaluation reserve	£20,000

A prior year adjustment will have to be done to reflect the provisions of Section 16 in FRS 102 as follows:

Dr Revaluation reserve £20,000
Cr Fair value adjustments (P&L) £20,000
Being reallocation of revaluation gain in the year to 30 April 2018

An additional deferred tax liability will have to be recognised on the fair value gain. If it is assumed that the rate of tax applied to the sale of the asset will be 17%, the deferred tax liability is calculated at £3,400 (£20,000 x 17%) and the prior year adjustment will be:

Dr Tax expense £3,400
Cr Deferred tax provision £3,400
Being deferred tax on revaluation gain as at 30 April 2018

2. Interest-free loan to subsidiary

This loan will continue to be treated as a current asset in Smallco's balance sheet because there are no terms attached to the loan and hence it is treated as being repayable on demand. The loan in the subsidiary's financial statements will be shown as a current liability to reflect the on demand feature of the loan.

3. Holiday pay accrual

The payroll clerk has calculated that an amount of £8,500 was due to the administration staff in respect of holiday pay accrued but not paid as at 30 April 2018. This is an increase of £1,300 (£7,200 less £8,500) on the holiday pay accrued at the date of transition. The prior year adjustment will therefore be:

Dr Staff costs £1,300
Cr Accruals £1,300
Being increase in holiday pay accrual at 30 April 2018

4. Director's loan account

As the loan made to the director-shareholder does not have any formal loan terms attached to it, this must also be regarded as repayable on demand in the prior year's financial statements. A prior year adjustment must be made to reallocate the loan from long-term liabilities to current liabilities as follows:

Dr Long-term liabilities £65,000

Cr Current liabilities £65,000

Being reallocation of director's current account in the prior year

Once the above prior year adjustments have been put through, the trial balance will be as follows:

Smallco Ltd

Trial balance as at 30 April 2018

	Dr	Cr
	£	£
Plant and machinery	104,801	
Plant and machinery depreciation		52,395
Fixtures and fittings	308,987	
Fixtures and fittings depreciation		235,851
Investment property	226,650	
Stock	13,002	
Trade debtors	632,114	
Prepayments	15,649	
Interest-free loan to subsidiary company	15,000	
Cash at bank and in hand	1,861,332	
Trade creditors		71,552
Director's current account due within one year		65,000
Corporation tax		164,664
Sundry creditors		8,546
Accrued expenses		24,700
Deferred tax		26,384
Share capital		100
Profit and loss account reserves		1,756,865
Sales		4,126,211
Opening stock	11,383	
Purchases	2,574,327	
Closing stock		13,002
Freight	351,104	
Director's remuneration	18,012	
Employer NIC on director's remuneration	1,449	
Staff salaries	143,904	
Fair value gain on investment property		20,000
Advertising	5,692	
Travelling	25,214	
Accountancy and bookkeeping	8,500	
Bank charges	2,334	
Depreciation charges	94,716	
Tax	151,100	
	6,565,270	6,565,270

Summary financial statements based on the above trial balance are as follows:

Balance sheet

	£	£
Fixed assets	352,192	
Current assets	2,537,097	
Liabilities		334,462
Provisions for deferred tax		26,384
Equity and reserves		2,528,443
	2,889,289	2,889,289

Profit and loss account

	£
Turnover	4,126,211
Cost of sales	(2,572,708)
Distribution costs	(351,104)
Administrative expenses	(279,821)
Profit before tax	922,578
Tax	(151,100)
Profit after tax	771,478

Impact on prior year profit at 30 April 2018

Profit after tax under the entity's previous financial reporting framework was £756,178 and under FRS 102 is £771,478 which is an increase of £15,300, which is reconciled as follows:

	£
Profit reported under previous framework	756,178
Fair value gain on investment property	20,000
Deferred tax on fair value gain on investment property	(3,400)
Increase in holiday pay accrual	(1,300)
Profit reported under FRS 102	771,478

Impact on previously reported equity at 30 April 2018

Previously reported equity amounted to £2,554,827 and under FRS 102 is £2,528,443 giving rise to a reduction of £26,384 which is reconciled as follows:

	£
Equity under previous financial reporting framework	2,554,827*
Holiday pay accrual to 30 April 2018	(8,500)
Deferred tax on fair value gain on investment property	(17,884)
Equity under FRS 102	2,528,443

*As per previous financial reporting framework:	£
Share capital	100
Revaluation reserve (85,200 + 20,000)	105,200
Retained earnings	1,693,349
Profit after tax under previous framework	756,178
Equity under previous framework	2,554,827
Holiday pay accrual	(8,500)
Deferred tax on investment property revaluations	(17,884)
Equity at 30 April 2018 under FRS 102	2,528,443

DISCLOSURE REQUIREMENTS

The requirement to disclose transitional information is an encouraged disclosure in FRS 102, Section 1A of FRS 102 (paragraph 1AE.1(e), and small entities are strongly advised to make the disclosures if there has been a material impact on the financial performance and position of the entity as a result of the transition to FRS 102. Where the disclosures are being made by the small entity, they should comply with the requirements of paragraphs 35.12 to 35.15, which are split into two parts: *explanations* and *reconciliations*.

Explanations

FRS 102, paragraph 35.12 requires a reporting entity to explain how the transition from its previous financial reporting framework to FRS 102 has affected its reported financial position and financial performance.

Reconciliations

There are certain reconciliations that must be included in a first-time adopter's financial statements to help users to understand the effect that the transition has had on the entity and must include:

a. a description of the nature of each change in accounting policy;
b. a reconciliation of equity determined in accordance with its previous financial reporting framework to equity determined in accordance with FRS 102 for both of the following dates:
   i the date of transition; and
   ii the end of the latest period presented in the entity's most recent annual financial statements determined in accordance with its previous financial reporting framework; and
c. a reconciliation of the profit or loss determined in accordance with its previous financial reporting framework for the latest period in the entity's most recent annual financial statements to its profit or loss determined in accordance with FRS 102 for the same period.

A new paragraph 35.12A was inserted into Section 35 as part of the triennial review which relates to an entity that has applied FRS 102 in a previous reporting period, but not in its most recent annual financial statements. Where this is the case, paragraph 35.12A requires the entity to disclose:

- The reason why it stopped applying FRS 102;
- The reason it is resuming the application of FRS 102; and

- Whether it has applied Section 35, or has applied FRS 102 retrospectively, in accordance with Section 10.

Using the example of Smallco, the disclosures to comply with the above may be as follows:

Reconciliation of equity

	Note	At 1.5.17 £	At 30.4.18 £
Capital and reserves (as previously stated)		1,778,649	2,554,827
Short-term compensated absences	1	(7,200)	(8,500)
Deferred tax on investment property	2	(14,484)	(17,884)
Capital and reserves (as restated)		1,756,965	2,528,443*

Reconciliation of profit or loss for the year

	Note	Year ended 30.04.2018 £
Profit for the year (as previously reported)		756,178
Fair value gain on investment property	2	20,000
Deferred tax on investment property	2	(3,400)
Short-term compensated absences	1	(1,300)
Profit for the year (as restated)		771,478

*For clarity, this figure can be proved as follows:

	£
Capital and reserves per FRS 102 at 1 May 2017	1,756,965
Profit for the year under FRS 102	771,478
Capital and reserves at 30 April 2018	2,528,443

Notes to the reconciliations

1. Short-term compensated absences

Prior to applying FRS 102, Smallco Ltd did not make provision for holiday pay (ie holiday earned but not taken prior to the year end). FRS 102 requires the cost of short-term compensated absences to be recognised when employees render the service that increases their entitlement. Consequently, an additional accrual of £7,200 at 1 May 2017 has been made to reflect this. The additional provision at 30 April 2018 is £8,500 and the effect on profit for the year ended 30 April 2018 is an additional expense of £1,300.

2. Investment property

The investment property is being measured at fair value under FRS 102, Section 16 which requires fair value gains and losses to be reported in profit or loss. FRS 102 also requires deferred tax to be accounted for on assets that are subject to revaluation. Consequently, additional deferred tax of £14,484 was recognised at 1 May 2017 to reflect the provisions of

FRS 102, paragraph 29.16. An additional provision for deferred tax has been recognised at 30 April 2018 amounting to £3,400. The gain on revaluation at 30 April 2018 has been reported in profit or loss and the effect on profit for the year ended 30 April 2018 is an increase in profit of £16,600 (£20,000 less £3,400).

August 2019

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